

Hedge Funds and Private Equity: Beneficial or Dangerous?

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Abstract

The paper deals with the changes in financial markets and the strategies of new financial investors, private equity and hedge funds. It is argued that the main causes behind the extraordinary growth of financial assets over the last three decades are the continuing upwards redistribution of income and the worldwide spreading of capital funded pension systems. In the new environment of over-accumulation of return-seeking financial assets financial investors play an increasingly important role and replace the entrepreneur as the central figure and driver for economic development. As a response to the mounting difficulties of traditional institutional investors to find sufficient returns “alternative investors” open up new *areas* (private equity) and develop new *strategies* (hedge funds) of financial investment to create higher returns for asset-owners. The problems which are generated by these financial innovations are proliferated through a competition-led contagion mechanism to the whole economy. They enhance instability, impose shareholder value orientation as new general pattern of corporate governance and exert considerable pressure on governments. Political countermeasures against the increasingly dominant role of financial investors should restrict financial speculation, protect firms and aim at a more egalitarian income distribution and at public social security systems to diminish pressures from financial markets.

JEL E44, G18, G2

1. Introduction

In mid-November of 2007 nobody can convincingly predict the economic and social consequences which the current financial crisis will have for economic development, employment and income in the world. While it is a well documented and undisputable fact that financial turbulence, disruption and crises are regular companions of capitalist development (see Kindleberger 1989) the effects have been very different even during the last 20 years. The New York stock market crash of 1987 left investment, production and employment almost entirely unaffected; the currency crisis of the mid-1990s in South-East Asia was the beginning of a severe and partly catastrophic breakdown of production, of mass unemployment and rapidly increasing poverty; the crisis of the European Monetary System 1992/93 broke out in a situation of weak economic development and accentuated this weakness, without triggering a recession. In this paper I will concentrate on the changes in structure of financial markets and behaviour of central actors which are sometimes disregarded in the discussion of the patterns and consequences of recurrent financial crises. It is argued that the long-term build-up of financial assets in an environment of less rapidly developing opportunities for productive in-

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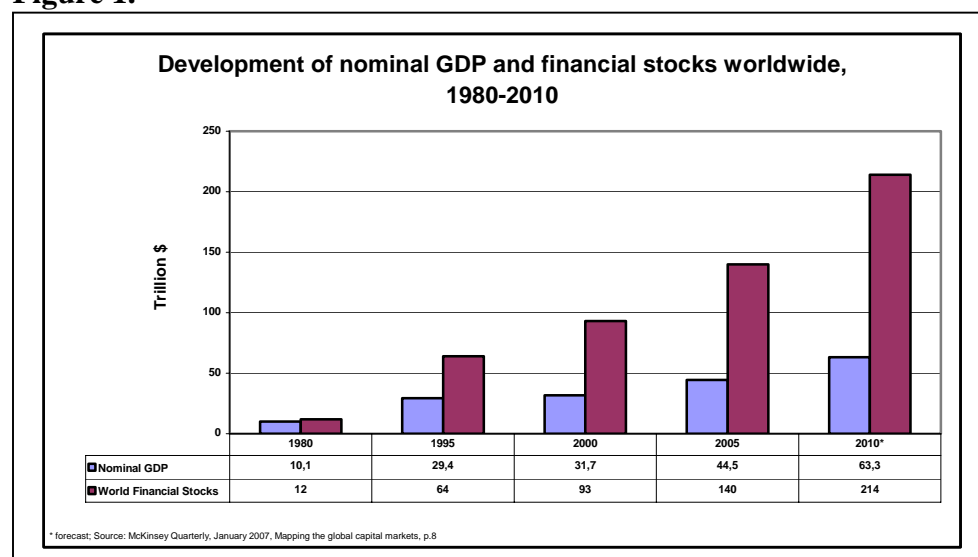
vestment the role and driving forces of financial markets and the behaviour of traditional actors on these markets are changing. The strategies of these actors not only perpetuate the traditional instability of financial markets, but exert new and stronger pressure on enterprises and employees on the one hand and on the other hand on governments and parliaments. This impact is also reflected in the liberalisation agenda of the European Union. The resulting instability and enhanced social polarisation call for political action. It should on the one hand try to stabilise financial systems via a stricter supervisory policy. On the other hand it should address the more fundamental problems which have led to the explosive growth of financial markets and which are located in the increasingly unequal distribution of income and privatisation of social security.

This paper is organised as follows: We start in section 2 with a brief description of the extraordinary growth and internationalisation of financial assets and its main historical background in the long-term upward redistribution of income and in the enhancement of capital funded pension systems. This is followed by a brief illustration of what is meant by a “finance-led” pattern of capitalist development as different from an “enterprise-led” pattern (3). The largest part of the paper (4) then deals with the main actors and especially with the emergence and strategies of private equity firms and of hedge funds, as “innovators” with regard to the traditional institutional investors. The resulting problems for financial stability, firms and their employees and for governments are discussed in section 5, followed by a remark on the current European financial markets policy agenda (6) which does not contain but rather exacerbate these problems. The final section 7 thematises perspectives for re-embedding financial markets into the framework of a democratic economic policy.

2. Accumulation and internationalisation of private financial assets

We start from the observation that there has been an extraordinary *growth of financial assets* in the world over the last quarter of a century. As can be seen from figure 1 worldwide nominal GDP in 2005 was 4,5 times higher than 25 years before, \$ 45 trillions after \$ 10 trillions. In contrast world financial stocks (WFS) had increased in 2005 to almost 12 times the amount of 1980, from \$ 12 to \$ 140 trillions. Whereas nominal GDP and WFS were of about the same size in 1980, by 2005 the latter had become more than three times larger than the former.

Figure 1.



Also the *internationalisation* of capital markets developed much faster than GDP and also than international trade (see figures 2 and 3)

Figure 2

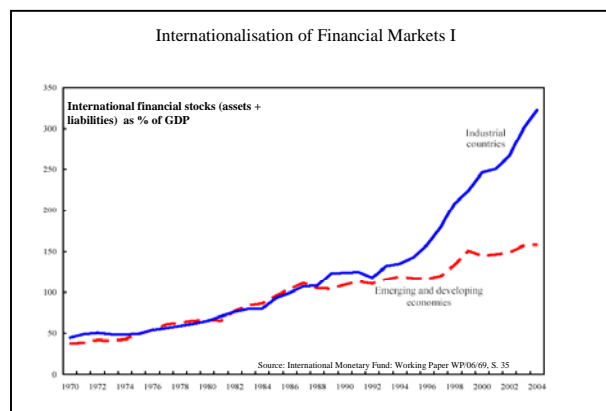
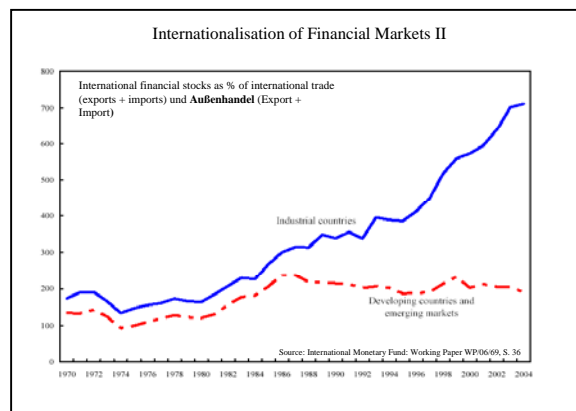


Figure 3

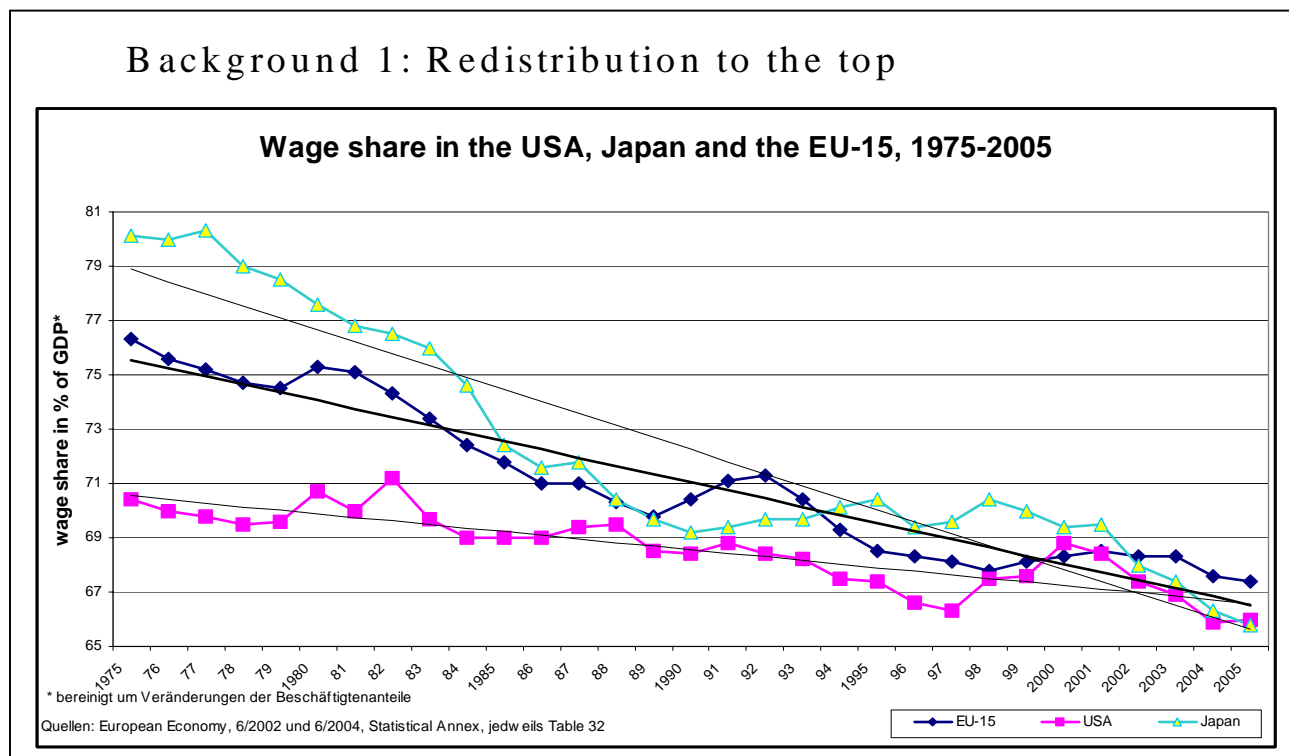


During the 1970s the amount of internationally invested financial assets corresponded to 50-70% of worldwide GDP; at the beginning of the current decade this ratio had risen to about 320%. This particular dynamic of internationalised financial assets also holds in comparison to international trade: the ratio was about 180% in 1970 and about 700% in 2004.

What were the background and driving forces for this extraordinary expansion and internationalisation of financial assets? Obviously internationalisation could not have happened without the shift of the regime of capital controls prevalent in the Bretton Woods world to a regime *of liberalisation of capital movements* since the mid-1970s. It is certainly also true that very extensive and generous and sometimes excessive *loan policies of banks* have played an accommodating role, particularly in the second half of the 1970s and during the last ten years. But the exclusiveness with which IMF and the Bank for International Settlements (BIS) have stressed credit policies as the decisive reason of financial expansion and “excess liquidity” seems to be strongly exaggerated. It disregards two other factors – located outside the financial system – which in my view play a large and lastly decisive role for the extraordinary accumulation of financial assets.

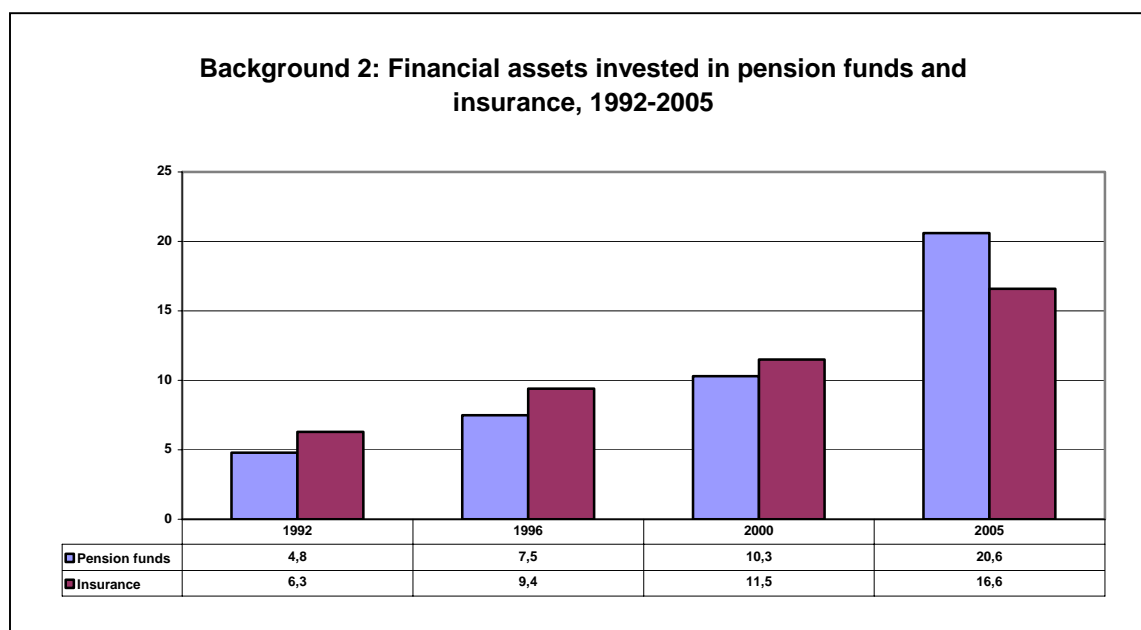
Firstly, the last 30 years have seen an almost continuous *redistribution of income and wealth* from the bottom to the top, basically reflected in the falling wage share (see figure 4) in the main developed regions of the world. This has led on the one hand to a massive concentration of financial assets in the hand of a small group of individuals and firms and, on the other hand, to a lagging behind of private consumption and a long-term slow-down in economic growth as a result of weak final demand.

Figure 4



Secondly, a further accumulation of financial claims took place in pension funds and insurance companies as a consequence of the extension of capital funded pension systems and the reform and privatisation of public PAYGO-pension systems. (see figure 5) Such reforms were actively promoted since the 1980s by international financial institutions like OECD and World Bank. Therefore not only rising profits and incomes of the richest parts of societies are the basis of financial expansion but a considerable part comes from the employees whose contributions to their old age security were invested in pension funds and live insurance schemes.

Figure 5



3. Excursion: The emergence of finance-led capitalism

The extraordinary long-term accumulation of a financial assets which are not channelled back into the productive circuit¹ has started to shift the role of the driving actors, bottlenecks and pressures of capitalist development towards a more finance-driven dynamic. This can in a very schematic way be clarified through figures 6 -8.

Figure 6

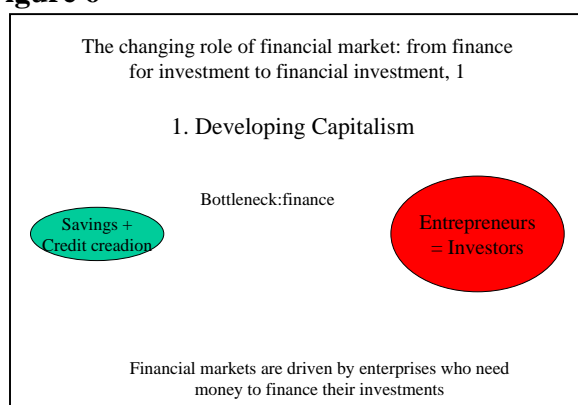
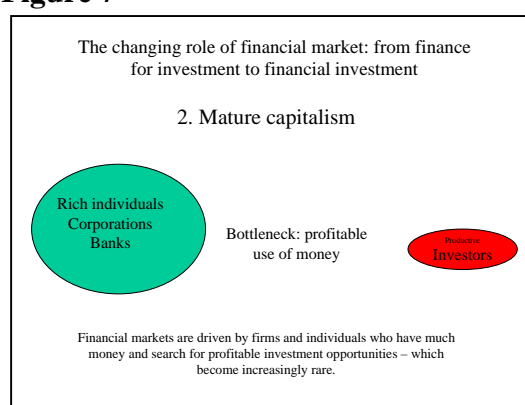


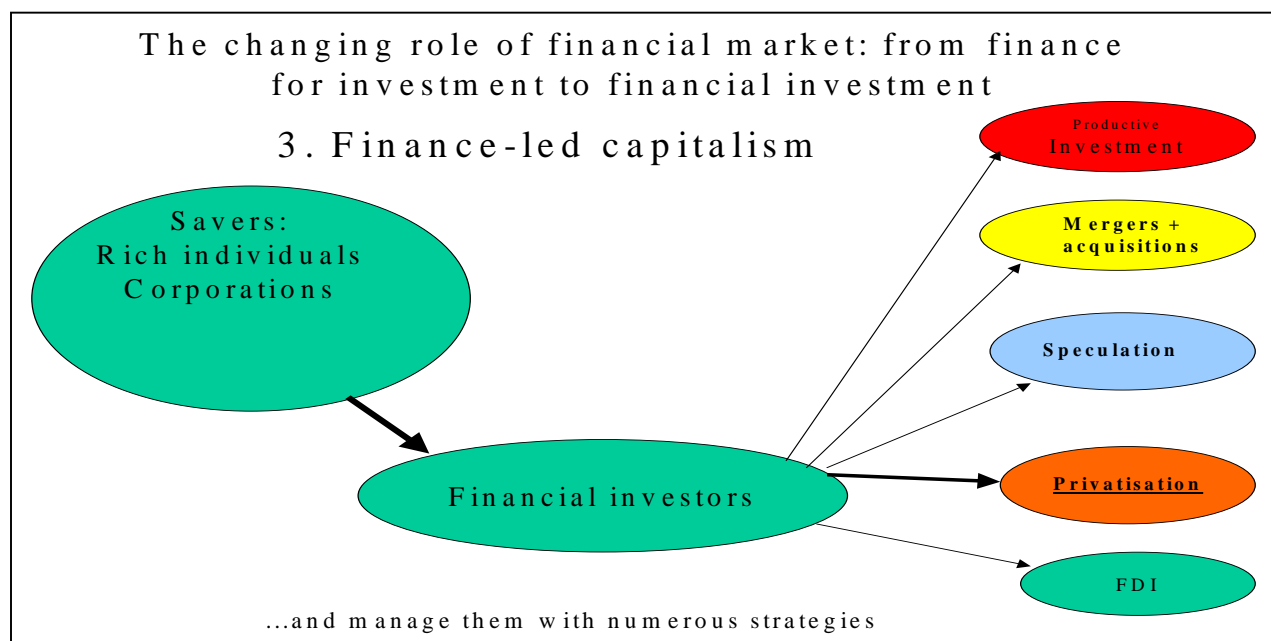
Figure 7



In developing and traditional industrial capitalism the driving actors were *entrepreneurs* (or managers) and finance was a bottleneck for corporate investment and economic development. (see figure 6) Finance was provided not only, and probably not even in the first place through savings, but mostly through credit creation via the banking system in interplay with the central banks. We had a situation of permanent macro-economic under-financing which had to be overcome by money creation via the financial system. By contrast, in mature capitalist economies we have no scarcity, but an abundance of financial resources under the form of financial assets - for which profitable investment opportunities are becoming increasingly scarce. (see figure 7) The bottleneck of economic development has shifted: from the provision of external finance (for the realisation of the amply existing profitable investment and production opportunities) to the search of profit opportunities for the use of amply existing financial assets. Under these circumstances *financial investors* replace the individual or corporate entrepreneur as the leading actor in development. They emerge as a new service industry, collect the money not only from firms and “High Net Wealth Individuals” but also the pension contributions from employees and invest them in a number of activities of which production of goods and services is only one option. Others are the organisation of mergers and acquisitions, privatisations, speculation, FDI. Capitalism becomes finance-led capitalism, at least in the developed centres. (see figure 8)

¹ This has also been observed by large international institutions like IMF and BIS. The fourth chapter of the Spring 2006 WEO is entitled “Awash with cash – Why are corporate savings so high?” and deals with this phenomenon, which puzzles the IMF.

Figure 8



4. Financial investors: Traditional structures and “alternative” investments

Altogether in 2006 there were almost \$ 80 trillions of private financial assets under professional management (see IFSL 2007c:6)². A little more than a quarter was privately managed by the owners or their trustees. Most of the remaining wealth was managed by “*conventional investment management*” or *institutional investors*. Only a very small part goes to so called “*alternative investments*”, i.e. private equity (PE), hedge funds (HF), and real estate investment trusts (REITS). The reason why we will in spite of these proportions in the following mainly deal with two of these alternative investors is that the recent emergence and remarkable activity of PE and HF indicate and herald a new phase of sharper competition between financial investors. These are private firms which compete against each other for the money of the savers who exert strong pressure on them to generate profits. At a certain point this becomes ever more difficult and strategies must become more aggressive. PE and HF as “alternative investment” are insofar a reflection of and a response to the crisis of institutional investment “as we know it”. PE is the extension of financial investment into the hitherto not explored *area* of non-quoted firms. HF represent the extension of financial investors into new *investment strategies*: speculation and shareholder activism.

a. Institutional Investors

Institutional Investors are the most important traditional form of management of financial assets. Their assets have grown very strongly during the last four years and are now 50% higher than at the peak of the latest financial market boom.(figure 9) Each of the three main

² This figure is considerably lower than the one given by McKinsey for worldwide financial assets (\$ 140 trillions)

groups of institutional investors (investment funds, insurance, pension funds) is in command of around \$ 20 trillions.(figure 10)

Figure 9

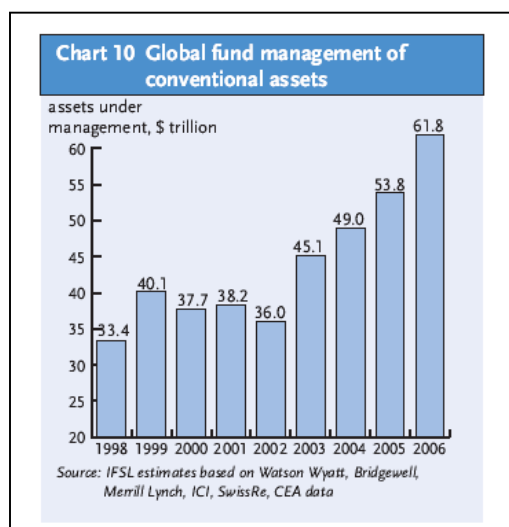


Figure 10

Table 4 Sources of global assets under management

\$bn, end-2006

	Pension funds	Insurance assets	Mutual funds	Total conventional	Private wealth ¹	Alternative funds ²
US	15,893	6,012	10,414	32,319	11,300	-
Japan	1,160	2,490	579	4,229	-	-
UK	1,686	2,469	787	4,942	-	-
France	133	1,863	1,769	3,765	-	-
Germany	116	1,571	340	2,027	-	-
Netherlands	827	428	109	1,364	-	-
Switzerland	456	368	160	985	-	-
Other	2,376	2,190	7,607	12,174	-	-
Total	22,648	17,392	21,765	61,804	37,200	1,500

¹ around one-third of private wealth is incorporated in conventional investment management
² estimate of hedge fund assets and private equity funds; ³ these figures only show domestically sourced funds for each country without regardless where they are managed
⁴ no reliable international comparisons are available for total funds under management in each country
Source: IFSL estimates based on Watson Wyatt, Bridgewater, Merrill Lynch, ICI, SwissRe, Hennessey Group and CEA data

Source IFSL, September 2007

The industry is rather concentrated: The four largest firms have each more than \$ 1 trillion under management and the ten largest manage 17% of total funds. (figure 11)

Figure 11

Table 5 Largest global investment managers

assets under management, end-2006, \$bn

1	Barclays Global Investors	UK	1,623
2	State Street Global Advisors	US	1,534
3	Fidelity Investments	US	1,300
4	The Vanguard Group	US	1,050
5	JP Morgan Asset Man.	US	898
6	Capital Res. & Man. Co.	US	850
7	ING Invest. Management	Netherlands	694
8	Deutsche Asset Man.	Germany	662
9	UBS Global Asset Man.	Switzerland	658
10	Credit Agricole Asset Man.	France	642
11	PIMCO Allianz Global Inv.	Germany	642
12	Northern Trust Glob. Inv.	US	640
13	AllianceBernstein L.P.	US	625
14	Axa Investment Managers	France	579
15	Prudential Inv. Management	US	568

Source: Global Investor

b. "Alternative" investors 1: Private equity(PE)

Private Equity firms are undertakings which collect money from the ultimate owners for closed funds, borrow additional money from banks, use both these resources to buy firms, restructure these firms and sell them after some time (from two to seven years), either on the stock exchange, or to strategic investors, or to other PE firms (secondary buy-outs).

There are *six participants* in a complete PE cycle: (figure 12)

- the owner of money or other financial assets, i.e. the ultimate investor
- the initiating undertaking (PE))

- the lending bank
- the fund created by the PE firm
- the target firm which is bought, restructured and sold and
- the purchaser of the restructured firm.

Figure 12

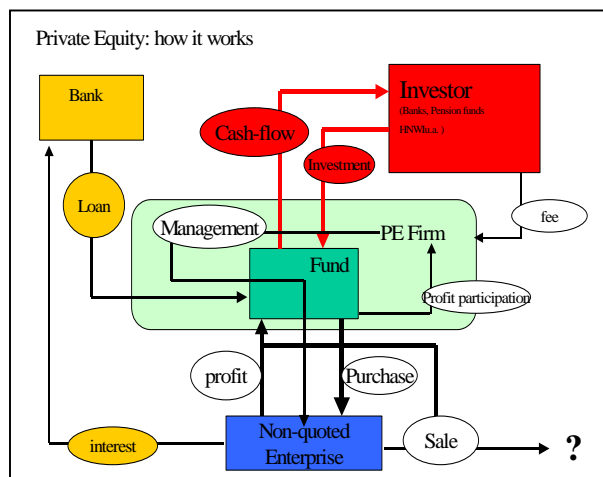
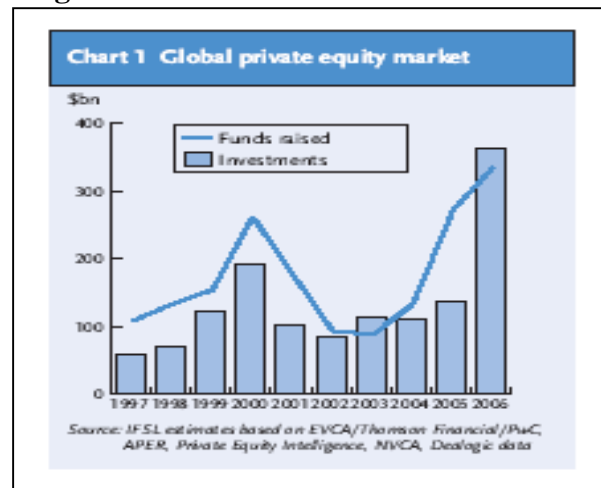


Figure 13



As can be seen from figure 13 worldwide PE investment developed in an unsteady way during the last 10 years: it rose steadily until 2000 then fell sharply and picked up slowly from 2002 to 2005. In 2006 it virtually exploded and reached \$ 365 bns., three times the value of 2005. In the first half of 2007 the strong growth continued before the sharp cut-back as a result of the financial crisis. The extraordinary rise of PE investment in 2006 is partly due to the fact that this year saw a number of mega-deals which have until then been rather the exception. Of the 10 largest PE-transactions since the end of the 1980s seven were carried out in 2006 or 2007 (see figure 14). Although the large majority of PE firms is of US origin (see figure 15) Europe is catching up, rapidly in terms of funds raised (where the European share rose from 21% in 2000 to 44% in 2006), not so rapidly in terms of investment (increase from 21% to 24%, see figure 16).

Figure 14

Table 3 Largest private equity transactions

Announcement year	\$bn
Equity Office Prop. Trust (2007)	38.9
Hospital Corp. of Amer. (2006)	32.7
RJR Nabisco (1989)	31.1
Harrah's Entertainment (2006)	27.4
Clear Channel Comm. (2006)	25.7
Kinder Morgan (2006)	21.6
Freescale Semicond. (2006)	17.6
Albertson's (2006)	17.4
Hertz (2005)	15.0
TDC (2005)	13.9

Source: Fortune

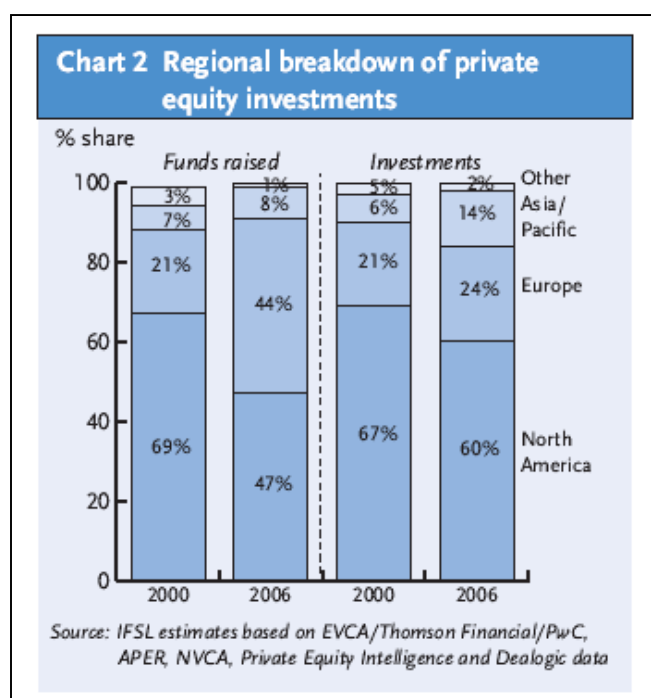
Figure 15

Table 4 Largest private equity firms

Firms ranked by amount of capital raised for direct private equity investment between 2001 and 2006	\$bn	
The Carlyle Group	Washington DC	32.5
Kohlebeg Kravis Roberts	New York	31.1
Goldman Sachs Princ. Investm. Area	New York	31.0
The Blackstone Group	New York	28.4
TPG	Fort Worth	23.5
Permira	London	21.5
Apax Partners	London	18.9
Bain Capital	Boston	17.3
Providence Euity Partners	Providence	16.4
CVC Capital partners	London	15.7

Source: Private Equity International

Figure 16



PE firms are also actively involved in the *privatisation* of public assets and services. The peak of this involvement was 2006: In five out of 59 large privatisation transactions with a total value of €40,4 billion PE firms were on the buyers side, paying a total amount of €10,4 bn. i.e. 25% of all privatisation revenues (see table 1).

Table 1 : PEF in privatisations in 2006

country	Company	% sold	Price €bn	buyer
Germany	Deutsche Telecom	4,5	2,68	Blackstone
	Woba Dresden	100	1,63	Fortress
	HSH Nordbank	24,1	1,27	Christopher Flowers
France	Pages Jaunes (France Télécom)	54,0	3,31	KKR
Netherlands	AVR Bedrijven (city of Rotterdam)	100	1,41	CVC Capital Partners
Total			10,3	

Source privatisation barometer Newsletters Nos 5 and 6

Specific features of the PE business model are

- Each fund is set up with a limited number of ultimate asset owners (closed funds)
- The legal headquarters of PE firms are usually located offshore to avoid financial supervision. By contrast, management is usually carried out in the financial centres, for Europe in London.

- High leverage: only between 20% and 40% of the transaction value in a take-over are financed through “private equity”, the rest through bank-loans to raise return on equity (as long as return on investment is higher than the cost of credit)
- PE firms are actively involved in the management of the newly acquired firms, with the objective to raise the value of the latter.
- The overarching strategic perspective of the management is the sale of the firm within a limited time-span; this perspective is from the beginning the dominant guideline for PE activity.

Problems:

- The medium-term exit-perspective determines *management behaviour* which will be focused on short-term cost cutting instead of developing long-term strategic perspectives and productivity raising investment. Most of these cost cutting measures are taken at the cost of the employees.
- A specific problem is the *increasing burden* through growing debt and debt service. The loans which the PE firm raises to finance a take-over are in most cases transferred to and must be serviced by the target firm.- which of course deteriorates its financial status.
- To recover the invested money as quickly as possible and even before the sale of a firm the managers increasingly often pay *extra dividends or bonuses* to the fund owners, and often these payments are financed again through bank loans. Such “recapitalisation” pushes the respective firm even deeper into debt.
- Under such circumstances problems of exit become more severe and the initial perspective to sell the firm to a strategic investor or bring it to the stock exchange becomes increasingly unrealistic. Instead firms are sold to second or third PE investors, who start the same business again and again. At the end of such a chain there are the “vulture funds” who break up the ailing firm and sell it in bits and pieces.

Of course there are cases where PE involvement has been beneficial for the firms which were bought, restructures, and resold. How frequent these cases are in comparison to total PE activity is largely unknown. More empirical research is therefore necessary. But apart from this it should be recognised that PE bring an *entirely different philosophy and culture* to the world of medium sized, often family-owned firms in which they are mostly active. (see figure 16a)

Figure 16a: The two worlds of family-owned and PE-owned firms

	Family-owned firm	Private equity owned firm
Objectives	Continuity Preservation of family wealth and reputation	> 20% net return on equity pa Implementation of institutional investors expectations
Strategy	Protection against potential dangers Continuous alignment	Higher risk = higher returns Rapid exploitation of hidden potential
Governance	Strong embeddedness in family, society and region	No external obligations
Time horizon	Long-term = 1 generation (=30 years)	Long-term = 5 to 7 years
Concept of firm	Social institution	Tradable good
Stakeholder	Customers, employees	Shareholders and managers of the PE firm

Source: Süddeutsche Zeitung 27/28. October 2007: 28 (translation JH)

c. "Alternative" investors 2: Hedge Funds (HF)

Hedge funds are assets which come from rich individuals and banks, and in the last years increasingly also from institutional investors (particularly pension funds) and which are invested by HF managers in high profit-high risk securities (*financial speculation*) or in quoted stocks where they develop *shareholder activism* to generate high dividend payments or to enhance market capitalisation or to boost takeover prices. (see fig.17) It is estimated that currently there are about 9000 HF managing about \$ 1,5 trillions of private money. (see figure 18) This figure appears peanuts in comparison to the \$ 62 trillions managed by "traditional" institutional investors. But it should be noted that HF operate on a highly leveraged basis and with 1,5 trillion private capital can invest about ten times this amount, i.e. about 15 trillions, which is then much less peanuts and much more coconuts.

Figure 17

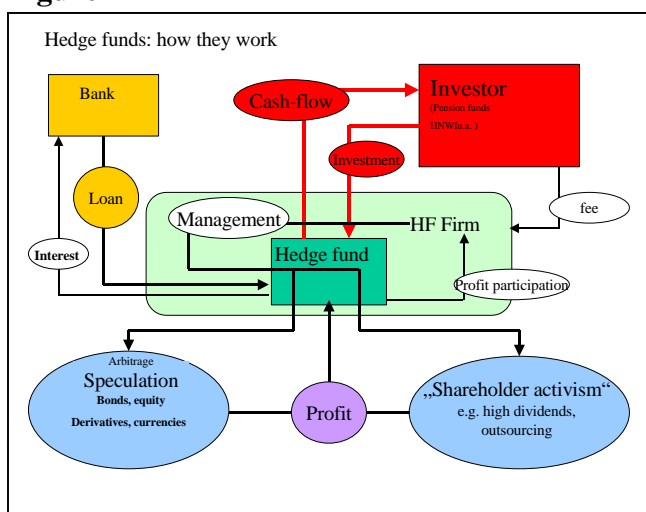


Figure 18

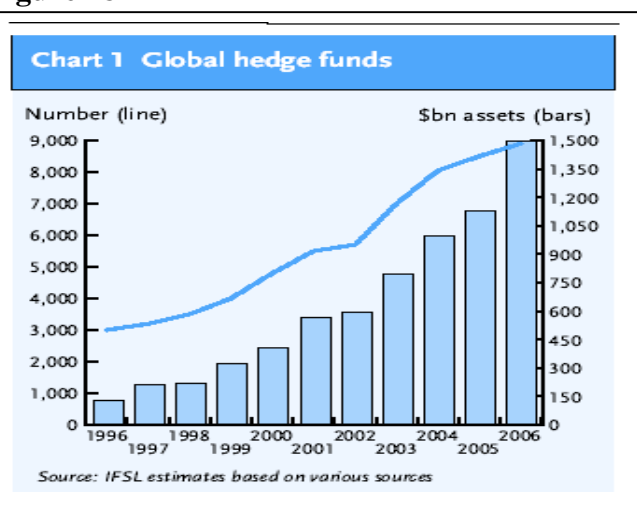


Figure 19

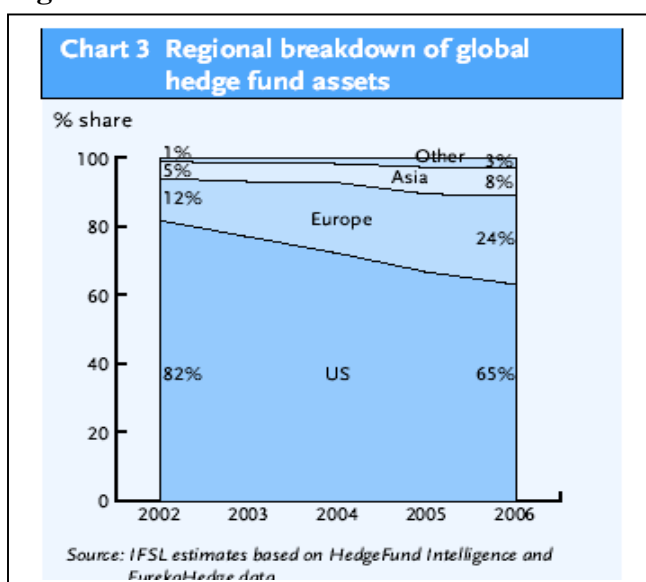
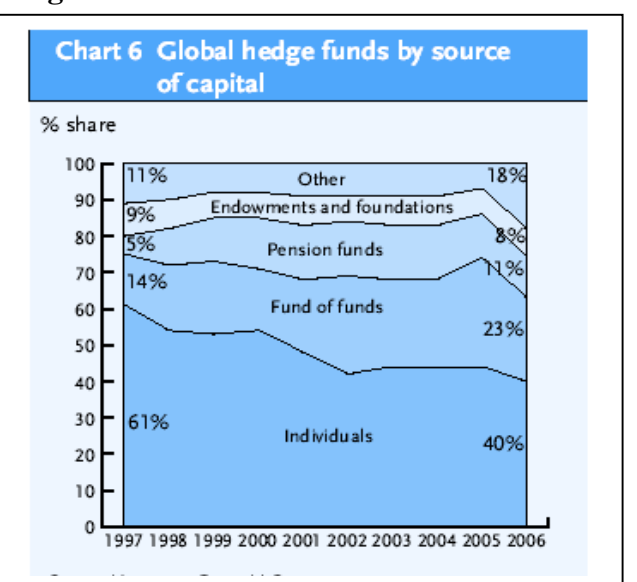


Figure 20



The traditional strategy of HF is *financial speculation*, which can lead to high profits or losses. A good example for the latter case is the Amaranth fund, which lost \$ 6 bns. within a

single week through a failed security speculation. Another and more recent example is the fact that HFs were prominent amongst the (highly leveraged) buyers of loan packages from the special purpose vehicles or conduits to which the banks had sold these loans. Thus they contributed to the worldwide contagion of the relatively small sub-prime crisis in the US.

The second strategy of *shareholder activism* is of more recent origin and perhaps reflects the fact that speculation is a very unreliable leg of business activity. The objective of shareholder activism is unambiguous: it aims at rapid and large cash-flows for the shareholders, often at the cost of the long-term strategic position and performance of the firm. The underlying philosophy of this strategy is that a corporation is an undertaking of shareholders for the shareholders and nothing else. All additional interests of different stakeholders must be disregarded. In this regard the strategic orientation of HF comes close to the restructuring activities of PE: Profits are generated not in the domain of circulation through speculative trading but in the realm of production through restructuring, cost cutting and enhanced production of surplus value, in Marxist terms through enhanced exploitation of labour.

4. Main problems : Destabilisation, enhanced pressure on firms and governments

The problems which are generated by the new generation of financial investors can be divided into three groups

1. they contribute to enhanced financial instability and crises
2. they push corporate governance in the direction of shareholder value orientation at the cost of employees and other non-corporate stakeholders
3. they exert pressure on governments for lower taxes, privatisation etc. and therefore tend to undermine political democracy .

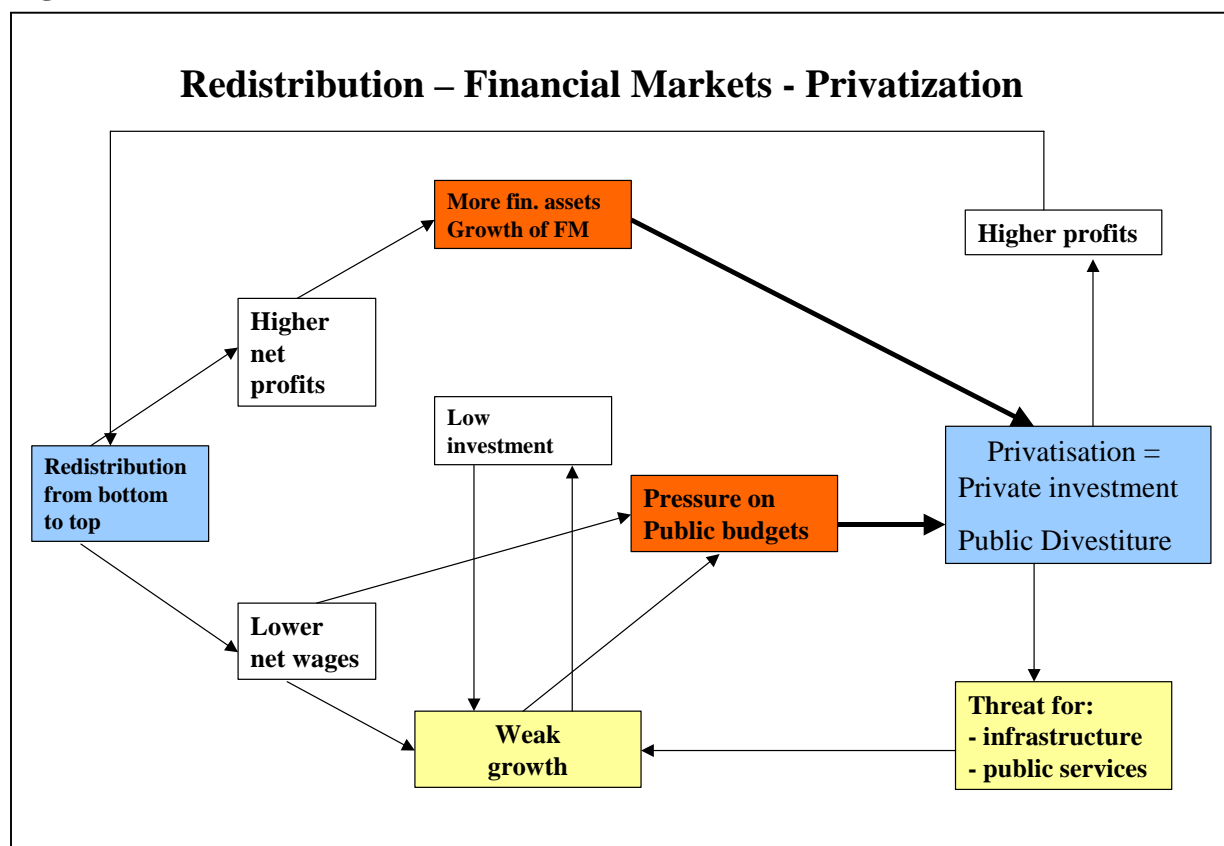
ad. 1: financial instability and crises: This is not a new phenomenon but it has been exacerbated with, first, the liberalisation of capital movements, since the mid-1970s (followed by the re-emergence of numerous financial crises), and, second, the rise of new financial investors. It is not so much related to PE but to HF. In all big speculative failures at least since the case of LTCM in 1998 hedge funds have been active drivers of financial speculation. In the build-up of the current crisis they have played an important role in buying risky loan packages from banks or their special purpose vehicles

ad 2: corporate governance. The problems of more aggressive re-structuring and shareholder value orientation do not only pertain to the firms immediately affected by PE activity and by HF pressure. At least as important and on the whole much more dangerous is the threat of *systemic contagion*. This is the proliferation of the aggressive strategies of PE and HF to traditional institutional investors which are the main pillars of financial investment and the management of financial assets. The mechanism is based on the fact that institutional investors are - mostly - private firms which compete for the money of their investors as ultimate asset-owners. Their main competition parameter is the promise to generate high returns for their clients. In such an environment hedge funds are *benchmark setters*, and the channel of proliferation of new corporate governance standards is competition. If one institutional investor places a part of its assets in PE or HF and receives higher returns this almost inevitably pushes other pension funds into similar financial instruments in order to prevent the exit of clients. This process is just going on in Europe. Particularly alarming is the fact that the share of assets which pension funds have invested in HF has more than doubled during the last decade, from 5 to 11%. (see figure 20), thus, on the one hand, exposing the pensions of employees increasingly to the risks of financial markets and exerting, on the other hand, increasing pres-

sure on these employees to work more for less money and on the state to cut social expenditure.

ad 3: pressures upon governments: Financial investors are one powerful force behind the almost obsessive *tax race* to the bottom to make a country attractive for financial and other investors. Such tax race undermines the revenue basis and puts public budgets under mounting pressure, which makes it increasingly difficult to maintain public services at the traditional and necessary level. This budgetary pressure is then a favourable background for the request by financial investors for the privatisation of public assets and public services. In the constellation of growing private financial assets seeking investment opportunities and growing pressures upon public finances privatisation appears as a solution to the problems of both the wealthy and the state: It gives the former a new area for investment and at the same time relaxes the financial burden for the latter. This is visualized in figure 21. Reductions of taxes on corporate profits, capital income and wealth increase the burden on public budgets and at the same time the revenue available to the wealthy. These use the additional money to buy from the government assets and service packages. In a net calculation the whole procedure simply amounts to a gift to the top: Governments give money to rich individuals and then sell to them for this money the public assets. From the social substance the whole process is nothing else than the transformation from public to private wealth – with negative repercussions not only for social cohesion but also for economic growth.

Figure 21



(It remains an open question whether this privatisation of public services under fiscal pressures fulfils its purpose to reduce the fiscal burden for the state. This is obviously the case when together with the privatisation public responsibility for the maintenance of the previously public service is abandoned – with the accepted consequence of a deterioration in the

quality, affordability, accessibility etc. of such services. In cases where government privatises services but maintains their provision as a public mission - organised via public regulation or PPPs - the costs of regulation or of buying or leasing facilities and services from the private sector may in a long-term perspective be higher than public provision even if this must be financed through public loans.)

To summarise and broaden the perspective: From the viewpoint of political economy the main problematic accompanying the growing role of financial investors in general and PE and HF in particular is the enormous shift of economic and political power in favour of capital. Financial investors are not only claiming ever higher economic returns for their assets; they are changing the social framework and environment for all economic and increasing parts of social activity, putting them under enhanced competitive pressure and forcing them to subordinate every tradition, social relationship and activity under the imperative of rapid returns to investment. The – relative – balance of power between labour and capital which had been achieved in the post-war period and was the basis for the continental welfare states in all their diversities is increasingly undermined by the dominating role and strategies of the new generation of financial investors. Social security as an unconditional right of every member of society is increasingly replaced with insecurity and precarious perspectives, the wealth of the upper classes increases and so does the number of poor people, even amongst those who have a job; social solidarity is replaced through individual competition – sometimes complemented by individual charity.

Against this assessment it could be objected that one should not put the blame for all evils in the world upon a limited number of financial investors, whose power would be strongly exaggerated. There is certainly some truth in this objection. In a broader sense one could argue that the general trend of development during the last three decades is the increasingly powerful neo-liberal counter-reform against the social and political achievements during the first two and a half decades after world war 2. But then I would still insist that financial markets are the main medium of this counter-reform and financial investors, and recently particularly HF and PE are very efficient executors of the general social and democratic roll-back which we are currently experiencing.

6. The European agenda: Open doors for financial investors

The current agenda of the EU for one the one hand, financial markets and, on the other hand, public services does not account for the new problems which arise with stronger activities of PE and HF for the provision of efficient, universal and affordable public services, when their provision is outsourced to private investors. Instead of stronger control and enforcement of public services commitments the scene is set for more deregulation, competition and market-opening in both areas.

In the area of *financial markets* the Commission focuses on stronger market opening and deregulation. Particularly two developments are remarkable:

- On the basis of a report on “*Special rights of public authorities in privatised EU companies: the microeconomic impact*” (Oxera 2005) the Commission has recently brought to the European Court of Justice an increasing number of cases for infringement of the open market for capital rule and therefore breach of the EC-Treaty. The recent ruling against special voting rights for the state government in the German VW is by far not the only case in this area.

In a recent *White paper on Enhancing the Single Market Framework for Investment Funds* (European Commission 2006d:13) the Commission declares its intention to “examine the types of marketing and sales restrictions that should be removed in the context of the shift to conduct of business rules at the level of the investment firm...” In this respect it seems to follow the recommendations of two reports of expert groups on HF and PE (see European Commission 2006a and 2006b) which were published in July 2006. Remarkably these expert groups who were appointed by the Commission consisted exclusively of representatives of financial institutions as if these were the only ones affected by the activities of HF and PE. Not surprisingly they recommended a further liberalisation of the markets. Particularly they advocate the removal of the – modest - national limits for investment of institutional investors in risky asset classes (like HF and PE) “which entail relatively high probability of very adverse investment outcomes” (European Commission 2006d:13.). With this it reinforced the deregulatory approach which was already the core of the “Market in Financial Instruments Directive” (MiFID” of 2004, which “replaces crude restrictions on the sale of certain instruments to certain categories of investors with a system which places responsibility on the investment firm to ascertain, on a client-by-client basis, whether a particular investment is suitable or appropriate.”(ibid.) .

The prohibition of such national barriers could and most probably would trigger a new stream of investment from pension funds in PE and HF.

For *public services* the discussion about the Green paper (European Commission 2003) and White paper (European Commission 2004) of services of general interest, about art. 16 of the ECT and about the Services directive have resulted in the formation of an – in spite of all rhetorical concessions - alarmingly neo-liberal position on the side of the Commission.. It is developed via, on the one hand, the overarching importance of the internal market and competition rules in the Treaty, and, on the other hand, the definition of an economic activity. The clearest example of this position can be seen in the case of *social services*. After these had been taken out of the Services Directives in spring 2006 the Commission announced and recently published a communication on social services, the thrust of which is identical with that of the Services Directive.(Commission 2006c) The decisive point is, that if a service is provided for money – regardless of the appropriateness of the price and of the ultimate source of finance – it is regarded as an economic activity and must be subordinated to the competition rules. In other words: An entity providing a public service (health, education) against money has to behave as if it were a private firm in a private market. With remarkable frankness the Commission concludes “It therefore follows that almost all services offered in the social field can be considered “economic activities” within the meaning of articles 43 and 49 of the EC treaty.”(ibid: 9) It seems logical that if social services have to be provided under conditions of open markets and competition there is no reason why they should not be privatised.

If these points of the EU agenda were carried out the likely result would be, on the one hand, more pressure for privatisation in hitherto largely publicly provided social services (e.g. in healthcare and education), and, on the other hand more shareholder oriented pressures on institutional investors in privatised firms as a result of enhanced PE and HF activity.

7. Summary and Alternatives

It has been argued in this paper that the long-term upward redistribution of income and the privatisation of social security systems have led to a very strong accumulation of financial assets in search for profits. This has pushed financial investors as a new private service industry to the centre and into a decisive role for economic and social development. Innovative

financial instruments, particularly PE and HF have through their specific strategies begun to dismantle cooperative structures of corporate governance at the firm level and to undermine the economic and political basis for the European welfare states. These problems call for political action and intervention. Following the structure of the problems generated by the strategies of financial market actors the proposals for political control and countermeasures can be divided into three groups: restriction of speculation, protection of firms and reduction of investors' pressure.

The *restriction of financial speculation* could be approached through direct rules for financial investors, for instance through transparency requirements or limitation of their leverage. The problem is that many of the new financial investors are domiciled offshore and cannot be reached. On the other hand, traditional institutional investors are usually located onshore. It should in any case be the rule that pension funds and life insurance should be strictly prohibited to invest in speculative financial instruments. This is still the case in some countries but such rules are under heavy attack from the financial industry. Such attacks must be resisted to avoid delivering pensions to the incalculable risks of financial markets.

The limitation of leverage is also possible via rules for lending banks, either by setting quantitative limits or by imposing higher capital requirements – 300 or 500% - for loans to HF and PE. Also the securitisation and sale of loans to special purpose vehicles should be prohibited or only be allowed under special circumstances; after all such trading is nothing else than the circumvention of credit restrictions which are set by the capital requirement rules. Further tools are taxation of capital gains, currency or other financial market transactions – and of course the set-up of a more cooperative international (regional or global) exchange rate system.

To *protect firms* from harmful financial investor activities it is essential to prevent in the case of PE the transfer of servicing obligations for loans which were taken to finance an acquisition upon the acquired firm or to withdraw money from this firm in the form of extra-dividends or bonuses. To make quick hit-and-run strategies by HF in large quoted firms more difficult, the voting rights of shareholders in such companies could be linked to the duration of their holdings, it could for instance only start one year after the acquisition of the shares. The provisions in the existing European take-over directive to oppose a hostile take-over should be strengthened and not – as is envisaged by the European Commission – weakened. They should give employees of a target firm not only the right to full information but also the right to veto a take-over if employees interests are not sufficiently met.

Reduction of investor pressure. Limitation of financial speculation and protection of firms against exploitation by financial investors are reasonable and – if carried out with sufficient political energy – efficient measures to stabilise financial systems and economic development temporarily. But they will not take the steam and pressure out of the system and will not prevent that financial investors which are under enormous pressure from high returns seeking asset-owners will search and develop new outlets and new methods of profit generation which will induce instability and polarisation in new and unexpected places and forms. A more comprehensive strategy to reduce the influence of financial investors in the economy and society must therefore address the roots for the financial pressure. The most important of these are located outside financial markets, namely in an increasingly one-sided distribution of income and an increasingly capital funded social security system. A long-term strategy to tame financial markets and to re-embed finance in a framework of reasonable and socially sustainable economic development must therefore reverse these trends: It must, firstly, initiate a redistribution of income from top to bottom through higher (minimum) wages and social ex-

penditure and at the same time higher taxation of wealth, profits and high incomes. Secondly, it should base pension systems on public schemes which are de-linked from the dynamics and risks of financial markets. Both strategies would considerably slow-down the accumulation of profit-seeking financial assets and therefore take much of the pressure from financial markets. Such strategies reach of course far beyond financial market policies.

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