The speculative appreciation of the stock market: a reply to a letter

Nick Beams
30 August 1999

The following letter, written by WSWS *Editorial Board member Nick Beams, replies to a message from a reader. The message is appended below.*

Dear JPW,

The stock market is a market for the titles to property. You are correct when you say that investment in shares does not add to the constant and variable capital, except when the shares are first issued to raise capital to start or expand a business. As a title to property, the shares traded in the market represent claims on the income (profit) generated by the business. When a share changes hands in the market, no new capital has come into the business. What has taken place is that the title to property and thereby a share in the income has changed hands. The constant and variable capital of the business remain the same as before.

If the market is continually rising, then, as you suggest, both buyer and seller are able to make speculative gains on their transactions, even though the underlying profitability of the firm has not changed. But this process of accumulating fictitious capital can continue only so long as money keeps flowing into the market and pushes up share values.

However, there are limits to this process. Clearly the higher the market goes, the greater will be the amount of money needed to flow into it in order to maintain the same percentage increase in share values. At a certain point the whole process must become unsustainable.

Consider the escalation of Wall Street in the recent period. Since US Federal Reserve Board chairman Alan Greenspan issued his famous warning about “irrational exuberance” at the end of 1996, the Dow has gone from around 6500 to over 11,000 today. Clearly the US economy has not expanded at the same rate over that period of time.

Where has the money come from? A large portion of the increase is due to corporations borrowing money in order to buy back their own shares and so increase their market value. One of the mechanisms driving this process has been the issuing of stock options to boards and CEOs as part of their salary packages. The operation is extremely lucrative. The corporate boards decide to buy back shares in order to boost “shareholder value” and the corporate chiefs are able to exercise their stock options and make a very handsome profit. The money to finance this process comes from corporate borrowing. In other words, companies are going further into debt in order to finance share buybacks which boost the stock market and enable large speculative gains to be made.

This process has intensified the concentration of wealth. An article published in the August 4 edition of the *Christian Science Monitor* noted that around 42,000 top corporate managers—comprising 0.00016 percent of the total US population—own a fifth of the corporate wealth.

But the methods of financing the share market boom are creating the conditions for extreme financial instability. In its August 6 edition the British magazine *The Economist* carried an article on the impact of stock options and buybacks. It pointed out that the cost of most executive share option schemes is not fully reflected in company profit and loss accounts and noted that attempts by the Financial Accounting Standards Board (FASB) “to require firms to set the cost of options against profits were killed by corporate lobbyists in 1995. They argued that if the cost of option schemes were treated in that way, fewer of them would be awarded, fewer people would have reason to maximise shareholder value and the economy would suffer.

“FASB did, however, manage to make firms include a footnote in their accounts detailing the share options awarded during the year. Smithers & Co., a research firm in London, calculated the cost of these footnoted options and concluded that the American companies granting them overstated their profits by as much as half in the financial year ending in 1998. In some cases, particularly that of high-tech firms (which tend to be generous with options), the disparity is even greater. For instance, Microsoft, the world's most valuable company, declared a profit of $4.5 billion in 1998; when the cost of options awarded that year, plus the change in the value of outstanding options, is deducted, the firm made a loss of $18 billion, according to Smithers."

As the article noted there is some dispute over these figures. But even if they are somewhat exaggerated, there is clearly developing a situation of growing financial instability.

Other figures point in the same direction. For example in 1998, firms announced repurchase of shares amounting to $220 billion compared with $20 billion in 1991.

A related phenomenon is the growth of margin loans in which investors use their existing stockholdings as collateral to borrow more funds with which to finance share purchases. A recent publication by the Financial Markets Center noted that the ratio of margin debt to GDP is at its highest level in 60 years and that if the average hourly wage in the US had been rising at the same rate it would now be $60. Margin debt has risen more than three times faster than household borrowing and overall credit market debt since 1993 and has tripled in relation to GDP over the same period.

On the question of bonds issued by the state to finance schools, highways, etc. In the final analysis money appropriated by the state represents a deduction from the immediate mass of surplus value available to be appropriated by capital in the form of profit, if it is raised through taxes, and a deduction from the future mass of surplus value if it is raised through loans.

Under conditions where the overall mass of surplus value is expanding, as was the case in the post-war boom of the 1950s and 1960s, capital can tolerate a considerable degree of state activity. Indeed, it welcomes such infrastructure projects as highways and schools inasmuch as they bring about general economic development.

But in the conditions which now prevail, where the overall mass of surplus value tends to stagnate or even decline, capital becomes increasingly hostile to all state deductions. This is why we have seen the running down of state infrastructure projects, the demand of the privatisation of former state-run services and their transformation into profit-making ventures, according to the "user pays" principle, as well as cuts to state spending on social welfare and education.

Yours sincerely,

Nick Beams

August 20, 1999

Dear Sirs:

Regarding the article "Fictitious capital and the rise of the Dow" by Nick Beams (30 March 1999), I have a few questions.

(1) Share market trading is speculation ... one trader's loss is another trader's gain. But if the market is constantly increasing in value over the years both seller & buyer will benefit ... the seller from the present transaction, the buyer from a future one.

(2) Entitlement to a share of the profits expected to be generated in the future: But if the share values are not used to add to constant or variable capital by what right or theory are they entitled to a claim on future profits?

(3) Bonds issued by the state: This example does not seem to be clear with respect to fictitious capital. Doesn't the money used through the issuance of bonds actually go toward capital formation such as schools highways, etc.?

There are other questions I have but a clarification of the above my help clear the others. This is not meant to be a critique of your article but rather to gain a better understanding.

Respectfully,

JPW