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Market Structures and Investment Behavior

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1. Introduction

The mature Asimakopulos was concerned with income distribution and investment. In his view the distribution of income was determined by the composition of demands a la M. Kalecki and of course Jerome Levy. For a no government closed economy where households do not in general have access to finance for consumption purposes, financed investment is the princple determinant of the distribution of income between wages and profits. It follows that the determination of financed investment demand is of particular interest in this Conference at the Institute named for Jerome Levy that honors Tom.

The extent, both structural and geographic, of institutional developments and changes in practice in financial markets throughout the capitalist world over the past decade has thrown light on the determinants of investment. Economists are to too large an extent an arrogant breed who disregard practice, institutions and legal structures in developing their views. This is especially evident in the analysis of investment.

Nowhere in the entire domain of problems economics is supposed to be concerned with is practice so dependent upon the institutional and legal structures as is the financing of investment. Orthodox economists who support economic theories which admittedly can find no use for the institutional details of the economy were well skewered by Mark Twain when he wrote::

> There is something fascinating about science. One gets such a large return of conjecture from such a small investment of fact. <u>Life on The Mississippi</u>

Financial market practice of the 1980's enables us to understand that the technical conditions of production are but one and not the dominent ingredient in determining investment activity. Furthermore developments in the 1980's clearly show that financing conditions, market structures, expectation formation and the technical conditions of production need to be integrated in the analysis of investment. After all capital is no less productive in

1992, when investment demand is week, than it was earlier in the post war world when investment demand was strong. The marginal efficiency of capital, a Keynesian concept, cannot be confused with a marginal productivity of capital assets as derived from some production function.

The developments in the 1980's point to the primacy of cost curves as embodying the decision variables for investment. Furthermore, cost curves can be interpreted as embodying accounting concepts both in the forward looking version of the pro forma's that are the locus of discussion in the negotiations that lead to decisions to invest and in the historic sense where realized profits as shown by income accounts are allocated among claiments as represented in the liability and organizational structure. The interpretation of cost curves as embodiments of the accounting data that enters into the pro forma's throws light on both the influence of expectations and market structure on investment and therefor upon the distribution of income.

The financial market developments of the 1980's and the impact on the performance of the capitalist economy in the 1990's of the indebtedness which resulted reveal the fallacies of the orthodox approach to the determination of profits. In neoclassical theory the profits of any unit depend upon it own productivity and market position. In the analysis of profits that follows the Levy-Kalecki-Keynes vision, the performance of individual units are linked by the macroeconomic relations which determine the aggregate of profits. A major implication of this insight is that the portfolio theory which was fortified by impressive mathematics and that guided the development of the junk bond phenomena is not valid for capitalist economies.

2. The light from the junk bond era.

The emergence in the 1980's of the merger and acquisition mania, including the hostile take over, revealed for all of us to see the calculations and the logic of corporate bonds. The take overs, hostile and friendly, take as their point of departure the cash flows that a business is expected to generate over a horizon which is given by the time to maturity of bonds and notes that can be issued to finance a take over. The price that can be paid in a take over is determined by the market's valuation of the complex of instruments that can be supported by the cash flow.

In the markets of the period a combination of bonds and notes, which pledged a high percentage of the projected cash flows, together with an equity base, which held a claim to the small residual projected cash flows, was priced to yield a much greater sum than the in place combination of bonds and notes, which pledge a much smaller percentage of the projected cash flows, and equities, which held claim to a large percent of the expected cash flows yielded. By the rules of the dominent theory of competitive markets, where money and finance are only veils, the market is supposed to price the cash flows generated by the underlying activities independently of the liability structure. The evidence from the 1980's contradicts this

Not only does the experience indicate that the market is not right always, for why could the same set of prospects carry such divergent prices one day to the next, but it also casts light on what is looked at during a decision to invest. In preparing a bid for a firm the first thing that is looked at is the historic cash flows, the gross capital incomes both before and after taxes, that the business generated. Behind the gross capital incomes lie the gross receipts of the firm. The difference is the sum of the direct costs of producing the output and the various indirect costs: management, research, advertising marketing etc. These indirect costs can be considered as the firm's business style costs.

These cash flow concepts translate into the cost curves of an economist. The total revenues are the result of the profit maximizing behavior of the firm, given its conception of the demand curve it faces and the costs it envisages. The demand conditions are analyzed in terms of whether the firm is a price taker or whether it has some degree of control over the market. Market power