Munk Advisory Services
ECOMENTARY™
MAS062309

# Managerial Capitalism in Default

We have been invited to speak on a panel on the economic outlook at the forthcoming meetings of the Western Economic Association in Vancouver on June 30, 2009. We saw this as an opportunity to look backward first in order to project forward. Clearly the Panic of 2008, from which we have not recovered, had antecedents in both macro policies over the period 2003-2007, but, in our view, it was also deeply rooted in the corporate governance crisis that has affected us for decades. That crisis, which we could term the Default of Managerial Capitalism, is an outgrowth of our incentive systems that apply to both managers of public corporate enterprises and the monitors who are supposed to watch over the operations of these enterprises for the shareholding owners. In short, both the managers and the monitors have failed us and caused a crisis in managerial capitalism.

In the period after the last great stock market boom (the tech boom as it was then called), as share prices declined, notable financial scandals appeared across the landscape. One common theme that emerged from these scandals was that various managements took on extraordinary risk, stimulated no doubt by the "pay for performance" incentives structures that had grown up in the prior decades. Those incentive systems were initially designed to reconcile the interests of managers and shareholders---a cure, so to speak, to the "agency problem," that economists had described so well in the 1980's. In fact, rather than suitable monitoring, our corporate governance system suffered an abject failure---because nearly all the gatekeepers failed to protect the interest of the shareholders. The failure involved fee-based corporate advisors and consultants such as auditors and outside general counsels. It extended itself to the commercial and investment banks, often to the detriment of the shareholders of these institutions. The failure also extended to rating agencies charged with the evaluation of the debt and equity of these companies, as well as the watchdogs at the exchanges on which these securities were traded. Finally, it encompassed the various regulatory agencies, such as the SEC, who were charged with enforcing various aspects of our security laws. It was a failure broad in extent and massive in magnitude. Yet, there was a saving grace in all of this, because as substantial were the collapses of such former titans such as Enron and WorldCom, and as painful as they were to employees and shareholders, the risks were confined. The individual corporate failures did not engender systemic risk and our financial system was kept largely intact.

A great deal was written about massive failure of corporate governance among so many large companies, and some changes in governance did occur. A major piece of legislation, Sarbanes-Oxley, was inspired by these financial scandals. While Sarbanes-Oxley was ostensibly designed to prevent financial catastrophes in the future, we know from the Panic of 2008 that it did not. It did impose substantial economic costs, particularly on young and small firms and allegedly it drove some firms to register their shares on overseas exchanges. At the end of the day, our capitalist economy resumed its growth trajectory, overly stimulated by easier credit conditions and a booming housing market. The Dragon's Teeth, however, had been sown.

These corporate governance failures remained unrectified. In fact, the pay for performance system was extensively employed by public financial companies. When these financials got into trouble, our problems were no longer micro in nature. They heralded a systemic risk---and the entire capitalist model of managerial capitalism was threatened by an increasingly invasive Government trying to stem the decline. While we are healing, the process still seems to be slow and economic growth has not yet resumed. Meanwhile, there is an ever growing invasion of the economy by regulators of every stripe and persuasion. The new proposed Financial Stability Act dictates even more. When we failed to reform our corporate governance system in the private sector, the Government is now in process in writing an entire, new regulatory system.

It was as if the "lessons of Enron" had been forgotten in the ensuing recovery. Apparently, we learned little and forgot quite a bit.

In order to determine where our economy is going, it is useful to recollect where we have been and how we arrived in 2007 with a massive financial infarct. The Fed of yore is gone. In its place are a two-trillion dollar Colossus (the Fed Balance Sheet) and a highly uncertain future for Federal Reserve independence. The TARP has caused Government to be directly involved in any number of financial institutions and TARP beneficiaries have seen their compensation systems altered radically under Government threat. Similarly, Boards of Directors have been pressured into a much altered scheme of responsibility. Some would argue that to "save Capitalism," Government is destroying it---or at least destroying the rules by which managerial capitalism had formerly functioned. Moral Hazard has become an every day term and the taxpayer has become the lender of last resort. We are now engaged in a very strange experiment, whose outcome is extremely difficult to predict.

Asked to join a panel on the economic outlook several months ago, I pondered whether economic forecasting was not a fool's errand, particularly when our institutional landscape had so visibly altered. It seemed to me that it might be more useful to describe the failures of managerial capitalism that we have witnessed in the past two decades and from there, get a handle on what might be in store for investors and citizens in the future.

There is a great deal of cant used to describe these financial events. To some, it is the "worst economic event" since the Great Depression. To others, it is a massive Banking Panic connected to a Federal Reserve policy menu that seeks to prevent a financial collapse by any means open to the Fed. And it may be that the economy will recover by the self-curative powers of a normal capitalist economy. It may even be true that real economic growth will resume in QII09. The "green shooters" believe that, even though the advocates of massive government intervention do not. In our view, the relevant message is to connect the problems of today with the earlier corporate governance failures in the past.

For the past several years, we have been attempting to finish a book on the corporate governance fiascos of the 1990s early 2000s. We call it "Disorganized Crime," largely because the ultimate 'crimes' were unplanned by their perpetrators. But the losses were very real even if the crimes were disorganized. The most interesting aspect of this history is that all that we learned and discovered about the earlier fiascos became a kind of guidebook for what we began witnessing as the housing bubble collapsed. As it were, the "Lessons of Enron." Went 'unlearned' or ignored. The Panic of 2008 is the logical extension of those earlier debacles but now, it is our credit system---the veritable blood stream of our capitalist economy---that has been infected. Apparently, few corporations seem willing to substantially alter their corporate governance landscape, and the Government is now stepping in with Giant Feet to do what we should have done for ourselves. This process can only slow our healing, but it has widespread public support. As economists we can preach to the public all day about the Cost-Benefit of enduring and forceful regulation actions and the likelihood that we will restrict the dynamism of a capitalist economy in the name of "safety" and "transparency." The true costs of the present experiment will not be known for years to come…just as the failures in corporate governance in the 1990s were unremarked as we allowed the housing bubble to grow such fateful proportions.

We attach our "presentation" file that we will use in Vancouver and invite your comments. We also note that a very simplified "short version" of these thoughts will appear in July, 2009 in a special edition of **Directors and Boards** when it appears. The hyperlink to our Vancouver presentation is to be found at www.ecomentary.com The Panic of 2008.pdf