Business Standard
VOLUME XV NUMBER 56

WEEKEND RUMINATIONS T N Ninan

A perfect storm?

They say that the phrase "the perfect storm" (which originated from a 1997 book by that name) should be banned because of its over-use. Regardless, it is worth asking whether the Indian economy is now headed for just that: A perfect storm — which can best be described as the simultaneous occurrence of several causes that make an event or storm much worse than if all those forces had not come together. What might be the elements of such a storm for the Indian economy?

The first is of course a doubling of oil prices in the last one year, with no prospect of an early slide back, or a reduction in import-dependence. This has the obvious consequences brought on by previous oil crises: double-digit inflation, a soaring trade deficit, and a skyrocketing fiscal deficit because the price increases in oil and downstream products like fertilizer have not been passed on fully, or even substantially. Not since 1991 have India's macro-economic balances been so out of whack.

That brings on a bunch of second-round effects. The sharply rising inflation rate forces the Reserve Bank to raise interest rates (expect another round soon) even though the economic tempo is slowing and therefore argues for lowering rates. Raising interest rates at such a time exacerbates the slowdown. Yet real interest rates on the deposit side are lower than the inflation rate; logically, they have to rise or banks at some stage will face a liquidity crunch. Rising interest rates at a time of growing deficits means that monetary policy will be running contrary to the fiscal situation, and this could crowd out private sector borrowers.

The third set of factors (linked to the first) has to do with the global liquidity surge. There is too much money sloshing around, and it is manifesting itself in the commodity price boom, and higher prices all round — construction materials like cement and steel, paper, cars and consumer durables. Once again, there is no quick remedy because the excess liquidity is a consequence of the US (both government and consumers) living beyond its means for well over a decade. Those excess dollars lie at the root of many of today's problems, and it is hard to see how anything other than tight monetary policy and severe contraction in the US can correct this.

Combine these with a cyclical slowdown in the global economy, financial crises in the US market with ripple effects elsewhere, and the backwash effects on the capital market, and you have a humdinger on your hands. The capital market is an immediate victim: share trading volumes have fallen by more than half, the feel-good factor has disappeared, the primary market has tanked, and everyone expects share prices to fall further — India is still an expensive market compared to almost all others, and because profit margins are bound to fall, the pressure is further downward.

The final element in the cocktail is the state of denial in which many people find themselves. This is to be expected when what has gone just before is five boom years. But large swathes of the commercial world have to adjust rapidly to the new reality — for all the surveys point to a sharp dip in both the business as well as the consumer mood. The counter-argument will be that advance tax collections are a hopeful sign, that company balance sheets are strong, and even a halving of profit margins in many sectors will still leave enough money in the bank for most companies. All that is true, of course, but anyone who does not recognise that the storm signals are flashing red is asking for trouble.

EXPERT VIEW Deepak Lal

Bilking shareholders

Anglo-American capitalism has become an instrument for enriching its business managers

With the recent actual or near collapse of many Western banks and companies as a result of the credit crunch, the massive severance packages that the failed executives have nevertheless walked off with (most recently, the sacked CEO of AIG got $35 million having overseen $30 billion credit-related write downs and losses), added to the scandals following the dotcom boom (of which Enron was emblematic), seem to have led many to question the very basis of Anglo-American capitalism. Instead of being agents creating shareholder wealth, the corporations at the heart of this form of capitalism seem to have become instruments for enriching their managers by bilking their owners — shareholders. How has this come to pass, and does it mark the beginning of the end of this form of capitalism, as governments bring in new regulations to stem growing public anger? Do these travails provide a justification for the alternative stakeholder form of capitalism pioneered by Germany and Japan? I deal with the former question in this column, and the latter in the next.

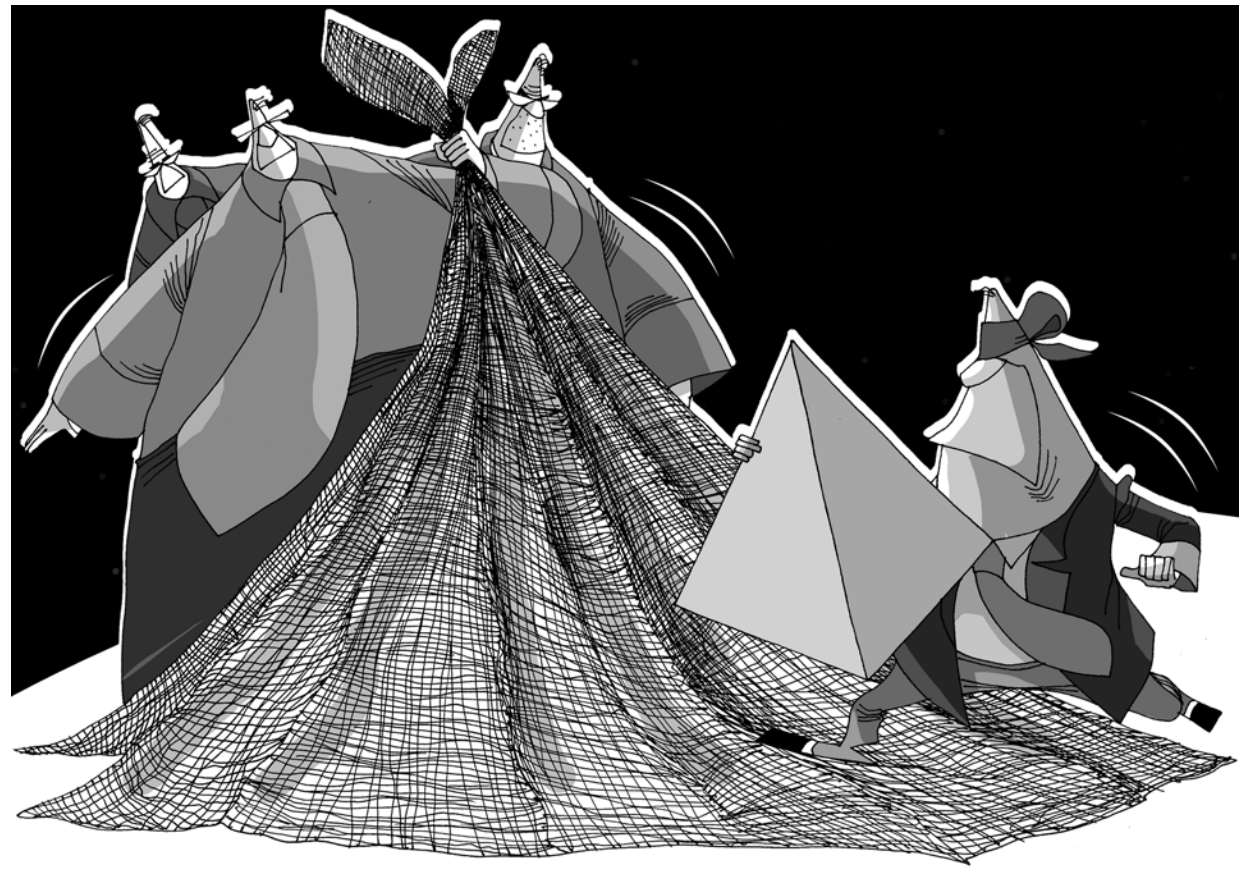

Illustration by BINAY SINHA

In the Anglo-American model of managerial capitalism, the separation of ownership (by a large number of shareholders) and control (by a small group of managers) leads to the "agency" problem. The former are interested in maximising the returns to their investment which arise from the firm's profits. The larger these profits, the higher the dividends paid out, the higher the return to the shareholders. Managers, though not indifferent to profits, would be more interested in using them for their own ends: Paying themselves higher salaries and reinvesting profits in expanding the firm to acquire greater power and status.

Given their large numbers and the attendant problem of 'free riding', the principals (shareholders) will be collectively unable to monitor the actions of their agents (managers) to see they are maximising shareholder value.It was the threat of hostile takeovers by 'outsiders' — hostile to the 'insider' managers of the company but friendly to its shareholders — which prevented managers from bilking shareholders. A company not maximsing shareholder value would be in danger of being taken over by a corporate raider who offered to buy the company's shares at a premium. The existing management would be sacked. It is this market for corporate control in which 'outsiders' could challenge the incumbent 'insider managers' which controlled bad managers. Despite his malign depiction by Hollywood, Gordon Gekko is good for the market!

In the fairly unregulated market for corporate control in the 1950s-mid 60s, in hostile takeovers, US shareholders received 40 per cent over the pre-bid price for their shares. But, with the howl of protests from threatened insiders (managers), the US passed the 1968 Williams Act which removed the highly profitable element of surprise in hostile takeovers by making it more expensive for outsiders to mount a successful bid. But this did not kill hostile takeovers as a wave of them restructured US business in the 1980s. This led managements of the largest US corporations to petition state governments for protection from corporate 'raiders'. The legislatures and courts obliged by allowing 'poison-pill' defenses against hostile takeovers, which declined from 14 per cent of all mergers in the 1980s to 4 per cent in the 1990s. As friendly mergers began to predominate, the incumbent managers agreed to cede control in exchange for lucrative consulting arrangements, stock or stock options in the acquiring company, generous severance packages, and other bonuses. Unsurprisingly, executive compensation soared as the costs of ousting incumbent managers rose with the restrictions on hostile takeovers. "Dollar for dollar, every increase in these costs could be claimed by the incumbent managers, either in greater rewards for themselves or in inefficient management policies." (H. Manne: "Bring back the hostile takeover", *Wall Street Journal*, June 26, 2002)

The rise in executive compensation from the attenuation of the market for corporate control was exacerbated by the double taxation of dividends. In both the US and the UK, shareholder profits were first taxed through corporation tax, and those paid as dividends were further taxed as part of the shareholder's income, reducing the post-tax return from holding shares in corporations. Most of shareholder returns were based on rises in share prices which in turn depended on reinvesting the company's profits in (hopefully) profitable investments. To motivate managers to take account of shareholders interests, their remuneration was linked to stock options. This gave both shareholders and managers a common interest in rising share prices, providing managers an incentive to manipulate their share priced through fraudulent practices (as shown up by the Enron and other scandals in the 1990s) and through taking high risk gambles with shareholder and depositor's money by the new 'universal' banks' in the current credit crisis.

The perceived ills of Anglo-American shareholder capitalism shown up by the 1990s dotcom bubble and the recent credit crunch — with their exposure of the explosion of managerial remuneration at the expense of shareholder value — are not therefore a sign of some decrease in corporate morality, but due to the perverse incentives created for managerial 'rent-seeking' by regulations limiting 'hostile' takeovers, the unintended effects of fiscal policy through the double taxation of dividends, and (as discussed in my columns of Dec 2007 and Jan 2008 on "The Credit Crunch") the promotion of universal banking where deposit taking 'commercial' banking part of these institutions — which can 'create money'— is conjoined with the — gambling —'investment' part. Removing these perverse incentives requires restoring the market for corporate control, removing the double taxation of dividends, and creating not merely a 'Chinese' but an actual wall between the commercial banks (with access to the lender of last resort facilities of the Central Bank) and investment banks. These would restore the Anglo-American model of capitalism which in its unfettered form has been a major engine of prosperity. Whether the alternative corporatist 'stakeholder' capitalist model can do even better is a question I take up in my next column.

VIEWPOINT Devangshu Datta

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