Introduction to the English Edition

Rarely before has a greater false doctrine been spread in so short a time than the American doctrine of shareholder value and stock-market–related value creation as the central factors of corporate governance. Rarely before was anything also proclaimed with so much smugness and self-righteousness as this false doctrine. It is wrong and damaging for the management of a company.

It would have been possible to have left the question unanswered for a while as to whether the shareholder value doctrine is suitable as a management philosophy, at least for the USA itself. But the scandals and corporate collapses indicate the opposite, and so far it is also not possible to see that the correct steps for corporate management are being taken.

The damage that has already been done all over the world is immense; but even more is probably yet to come. The financial losses are not even the most important thing, although these, too, are larger than at any other time. It is the immaterial damage that counts. Much more significant than the money are top management's loss of credibility and the loss of trust in the senior management of large corporations. Added to this is the far-reaching miseducation of two generations of managers, who have learned nothing apart from the doctrine of shareholder value and who are incapable of imagining that it is false and that there are alternatives to it. They are so miseducated that the necessary retraining is difficult or impossible.

In the meantime, doubts about the magic recipes have spread. Lack of orientation and perplexity have arisen; the result is helplessness. According to temperament, what follows may be either lethargy or activism. It is time to stop imitating American management methods, in particular those for corporate governance.

Two errors in reasoning have led to the naïve imitation of seemingly superior US management methods. The first is that the US economy is strong. In fact, it is merely large. The second error is to believe that the reason for this strength is that the management of US companies is good and superior to management all over the world. In fact, American management can only be used where it is has to deal with simple conditions. For complex, multicultural, or even global tasks it is unsuitable and damaging.

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The US economy is in a desperate state, which is disguised by wrong figures, tendentious media reporting, and a dubious economic theory. Neither the growth rates for the economy nor the employment figures are correct; the profit figures for companies are not right and the economic recovery is not worth mentioning when it is compared with the six recessions since the Second World War. The theory of economics dominant in the USA, that of the "asset-based, wealth-driven economy", is one of economic history's ironies.

America has many large companies that impress managers around the world and stimulate imitation. The USA does not owe the size of its companies to the quality of their management. US companies are large because they have something that has never otherwise existed in a developed country, namely, a big and largely homogeneous domestic market. It is no wonder that large companies arise where there are about 290 million consumers who all speak the same language, who pay in the same currency, and who, to a large extent, have a mentality which makes the consumers receptive to uniform advertising and promotion and which makes uniform product design possible. Management is simple when there are no customs frontiers to be overcome and where regulations and tax laws are all the same. None of this existed in Europe until a short time ago. We can only envy the Americans their comfortable situation; we shouldn't imitate them.

The export quota of the typical US company is small or nonexistent; that of the typical European company is large. America is an importing nation; Europe lives from export. Where English is not spoken, American management soon ceases to work. For these reasons, the USA is by no means, as people like to believe, the center of global thought and business activity. On the contrary, the center is where more than five hundred years ago business relations existed with China and Japan, without E-mail, cell phones, and jet planes, and where hardly any fuss is being made about globalization because it has long been nothing particularly new. That center is Europe.

For the reasons mentioned, it is much easier to manage a large company in the USA than in Europe. There is therefore no cause to look at America in order to learn about management for complex situations. American management is like doing the standard compulsory figures in ice-skating; managing a large company in Europe is like doing the more demanding freestyle.

As a result of the shareholder value doctrine, a type of manager has reached the very top of major companies who previously would hardly have had a chance: the money-driven manager, who is unable to distinguish the logic of the real, nonfinancial economy from that of the financial economy, because for him the only thing that exists is what can be quantified in money. This type of manager could be described as the *monetarist manager*. It has little or absolutely nothing to do with good corporate management. Genuine management begins in any case where quantification, especially quantification in money, is no longer possible but where nevertheless decisions and action have to be taken.

Consistent in his error, the monetarist manager believes that the supreme goal of a company is profit, because he is not able to see that in a market economy there are essentially no profits but only costs: the costs of current business and the costs necessary to stay in business. This type of manager is also not capable of distinguishing between dealmakers and genuine entrepreneurs or between the company as the object of crafty financial moves and the company as a productive social system.

The shareholder value doctrine has failed and what is thought to be its salvation, the stakeholder approach, is a step backwards. The Americanized managers with their MBAs will now have to change their ideas quickly and fundamentally. They will have to construct a completely different notion of the company which does not focus on interest groups, either shareholders or stakeholders, but on the company itself. The company itself, its health, and its viability have to form the criterion for corporate governance.

Those managers holding an MBA will also have to learn that managing a company does not consist in solving case studies but in exactly the opposite, namely recognizing where what case could be brewing. If everything can be put down in writing nice and neatly in a case study, a case is no longer a problem but merely the carrying out of work. If a business plan à la business schools can be drawn up, others have long done the work, because they reacted to the faint signals instead of waiting for the ten-year cashflow analysis. Business administration is what the name says it is: *administration* and not anticipatory, entrepreneurial, or even strategic action.

This generation will find that the orienting factors propagated around the world as ultimate truths – shareholders, stakeholders, value creation – are in fact the opposite, namely *disorienting* factors. For this reason, lack of orientation and perplexity are already to be seen in top management; they are less and less easily concealed, even if still glossed over with posturing and showing off.

Preface to the English Edition

In this book I take a view of corporate governance that is fundamentally different from the more or less prevalent view taken in the second half of the nineties. To a major degree, it is diametrically opposed to this latter view. Right from the very beginning, and unlike virtually everybody else, I have taken as my point of departure not wealth for the shareholders but the ability of the company to perform. My thoughts have been focused on the strong, healthy, and viable company and on the question of how it should be managed and supervised.

There have been comments on the subject suggesting that there are no real but only apparent differences between the two ideas – shareholder value on the one hand, and the high-performing company on the other. It has been said that in fact they are the same thing or are very closely related. Above all, it has been claimed that an orientation to shareholder value necessarily and automatically produces a healthy company. I have always had a different opinion and, for logical and empirical reasons, have never accepted this latter view.

It is now being shown, in a fairly dramatic way, that this view is in fact utterly wrong; that not only is it not correct, but that actually the opposite has happened: the shareholders have become poor and the companies weak, and some of them are in a desperate state.

The inspiration for this book came from Germany. However, I did not want to confine myself to the situation in Germany but wished instead to consider the topic of corporate governance on a broader basis. The legal context in different countries certainly varies, but the management issues are the same everywhere, and to a large extent the answers are also the same. Management forms and styles may differ, but in the end there is only one kind of management; namely, good and effective management. In my view, that can be achieved everywhere regardless of the differing legal contexts.

I have thus chosen a general terminology and use the expressions *governing body* or *corporate governance* for the German or Austrian supervisory board and also for what, in my view, the Swiss administrative board has in common with it – and for what they should both be doing. The term *executive body* relates to the role of the board of German or Austrian joint-stock

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companies, the management of companies with limited liability, and Swiss businesses, which are normally joint-stock companies. *Top management* and *corporate management* almost always mean both of these bodies unless it is clear from the context that this is not the case.

This book necessarily deals with the corporate management of a business, for the governing body cannot be understood nor logically controlled without the executive body, and vice versa. It is however written primarily from the perspective of and with regard to the governing body. For this reason, important topics relating solely to the executive body are not considered here. Executive top management alone would of course justify a book in itself, and thus the aspects examined here are primarily those regarding the *interaction* of these corporate bodies.

The basic premise of this book is that corporate governance *can* and *should* manage – in a quite specific sense of course and while upholding the executive body's integrity and ability to function. In countries with a one-tier corporate management structure, this is self-evident. What is not always quite so clear, however, is how this should be done in practice. In countries with a two-tier system, this topic may initially prompt certain scepticism or even be perceived as provocative. Nonetheless, I consider it essential to strive for this solution for reasons that I hope will be made clear in this book.

My intention is not to produce another scientific treatise to add to the scores already in existence. This book is instead intended as a practical guide to the effective design of corporate management and in particular corporate governance. Hence, special cases and exceptional situations are not discussed.

Since the heart of the trouble as I see it is not the supervisory bodies as such but the errors of corporate governance, I have changed the original title of the book by making what was previously the subtitle into the title. In that can also be found the starting points for the required reorientation and for the restoration of the economy to a healthy state. However, the key to right and good corporate governance is, of course, the top management, its executive body, and its supervisory body. It is the supervisory body that has the final responsibility; it is there that the expert knowledge is needed; it is there that the courage has to be shown to take a stand against the trends of the day and the idiocies of fashion and, something that is seldom appreciated, it is the supervisory body that is the correcting mechanism that operates in advance of the market. The market does work, but there are important ways in which it works too late. The market does not prevent mistakes, it simply punishes them. They have to be prevented by the top management and, in the final analysis, by the supervisory body.

The first edition of this book appeared in German at the beginning of the period when a whole system of errors and misunderstandings relating to the term corporate governance, at the center of which was shareholder value, was being generally propagated.

For the second edition, which appeared (also in German) at the end of 1998 or, in other words, in the middle of the great stock exchange boom, I wrote in the preface that the growth in the American economy appeared to be an exception to the general stagnation, but that in fact the potential there for an implosion or for instability had become not smaller but greater. Those were the days when people still believed that in the "New Economy" there would never again be any cyclical ups and downs, and one well-known economist took the view that "this expansion will run forever".

The third edition, which is here translated into English, appeared at the beginning of the phase of disillusionment and doubt about the correctness of shareholder value as a guiding principle for sustainable corporate management. My view is that that really does mark the beginning of the end for this economic and management paradigm. I mentioned the short life that could be conjectured for it in chapter 4 of the first edition of this book. There are more and more indications that its decline could be accompanied by a collapse of those economies and companies that believed this approach should be followed with particular exactness. There have already been some initial cases of this.

I saw no reason to make any amendments to the text of the book. The Great Transformation of business and society that is described in chapter 3 is in full swing. Neither at the time nor now was there any reason to interpret this as any sort of "New Economy", even though, by the time it comes to an end, we shall probably have a New Society. And the errors of management described in this book are continuing to be made, though in some cases under different names. As I mentioned in the preface to the second edition, they have also been joined by a few more.

Rather than making amendments to the text, I have written a detailed new introduction, in which I start by giving a summary of the position I adopt and relate it to the developments since the book first appeared.

I have also added two appendices, in which I discuss two particular subjects in detail. The first of these subjects is the fact that the much-lauded American economic miracle was not a genuine miracle but a phony one. This is an important point because the American economy, which appeared to be booming in contrast to the stagnating economies in Europe, was the strongest argument in favor of the claimed superiority, and hence the spread, of the shareholder value theory, as well as the sort of corporate governance that was based on it.

The second appendix is a discussion of the other “miracle” that the advocates of the wrong sort of corporate governance appeal to for support, that of the “New Economy”. Both these miracles have proved to be deceptive mirages; unfortunately though only after the false management doctrines based on them had had their effect.

The book is divided into two parts. The first part considers the direction in which corporate governance should develop and why. Chapter 1 raises the question of whether corporate governance should manage. Chapter 2 looks at how the governing body functions today and where its functional shortcomings are. The third chapter considers the question of whether corporate governance is equipped for the future, even if one feels it has been so in the past and is in the present. It also looks at whether corporate governance is properly prepared and effective enough for the radical changes currently experienced by economy and society in almost every country, for what I call the Great Transformation. Chapter 4 is devoted to the question of the standards by which an enterprise should be managed and in whose interest an enterprise should be run, regardless of industry and business area. It is in my view essential that the governing body should be involved in clarifying these issues and have the last word in answering them. Following this, the fifth[*] chapter discusses the variables and benchmarks for assessing a business, in particular in the light of the question of what a healthy business is and how its health can be assessed.

The second part looks at the “what” and “how” of corporate management. Chapter 6 provides a brief overview of the elements of the company constitution (also known as corporate bylaws). Chapters 7 and 8 consider the issues surrounding the formation of supervisory and executive bodies, their roles, how they function, and the principles for their effectiveness. Chapter 9 takes a view on the difference between management and leadership, the latter of which is threatening to become a fashion trend. It is precisely the top corporate bodies that need to look very closely at this difference, for it is from the top of a business, if anywhere, that leadership stems. Chapter 10 goes to the very heart of the problems of power, responsibility, and liability. And chapter 11 examines the key issues of personnel selection and recruitment to the most senior positions.

The book is thus intended first and foremost for top managers and for all owners of company shares. It should further be of interest to anyone who has to work with senior managers or those on the higher managerial echelons. And finally, it may well be of use to anyone with a broad interest in general business management or who has to take an interest in it for professional reasons – for anyone who has any interest in a well-functioning economy and society.

[*] Translator’s note: This reads “fourt chapter” in the German. I presume that “fifth” is meant.

The economy is unmistakably in a phase of experimentation. Solutions need to be found for new problems, and seldom before has it been possible to study attempts to do so and the effects of them so well. The basic tasks of corporate governance I describe in this book are therefore still highly topical.

A brief word about individuals' and company names: descriptions of actual cases and examples would perhaps have been useful illustrations in the book, and may also have pandered to the public's taste for sensation. However, I have exercised extreme restraint in this regard. Although I am quite familiar with a few real-life examples of dramatic failure by supervisory and executive bodies, I do not think it is right to detail dates, facts, and names. It is my opinion that name-dropping does not provide any useful information; furthermore, it could wrongly implicate people whose involvement was not causal, and in many cases even the person actually responsible may previously have produced excellent performances in other domains. As I will establish, success and failure do not depend solely on people but also and to a considerable extent on the situation in which they are placed – a situation that they all too often did not seek out. In the final analysis, this is no excuse; the consequences of failure cannot be ignored. However, people and situations must be considered in close relationship with each other.

That is precisely why I make no attempt to improve the effectiveness of corporate governance primarily by *people-driven* proposals, but instead by *constitutional* controls. This thinking pervades the whole book and is, as I am often able to see at first-hand, largely a new concept for business managers with a technical or scientific background. Lawyers in contrast have no problem in accepting it. They know from their own discipline that if anything will work, a constitutional solution will.

Where I do name people in this book, I have abided by the following principles: first, the people are no longer alive – in fact in most cases they died quite some time ago. I know there is huge interest in examples of today, but in my view a certain chronological detachment is needed to be able to come to a relatively reliable assessment of someone's performance. In the media world of today, judgements – and prejudices – are, it seems to me, made too hastily and without proper thought. Second, other than a few exceptions, which seem well justified, I have only mentioned people in positive terms. Third, I only use the names of people where I believe I have studied their lives in sufficient depth to be able to form an opinion. I have no truck with the popular game of "name dropping". Based on these principles, I hope I have dealt fairly and honestly with a topic that is discussed almost exclusively in terms of personal categories.

The views expressed in this book come from a number of sources. They stem from experience I have gathered in my professional activity with top management bodies as a consultant and as an active member. A further source is numerous talks with managers who are on governing bodies or who work with governing bodies as executive managers. Furthermore, the content of all the chapters in this book have formed the material of countless lectures and above all seminars I have held for thousands of managers over the past twenty years. I have been able to learn a great deal from the ensuing discussions, and in this perspective, the views expressed here and the suggestions proffered have most certainly been put to the test. Without any false modesty, I would also say that a large number of current managers and entrepreneurs have told me that these seminars have helped them gain a new and better perspective.

I would like to thank the many managers with whom it has been possible for me to discuss the problems of corporate governance in seminars and at lectures and whose critical attitude demonstrated that they had quickly and rightly become concerned about the direction in which things were developing. They became so because their experience told them there was something about this loudly trumpeted new type of corporate management that could not be right.

Although they were also obliged to pay lip service to what the stock-exchange analysts were saying, they managed their companies from totally different and correct points of view. They kept quiet for a time for tactical reasons, because they needed to spend their time on something more important, namely on managing their companies well. And perhaps they did not always have their counterarguments ready to hand, neatly grouped and organized, particularly when the "experts" tried to make a big impression with complicated formulas for calculating things. What they had instead, though, was a good sense of what is right and what is not, which is perhaps the most important ability that competent managers can have. Also influential in writing this book was the outcome of discussions stretching over one and a half years in a focus group initiated by Dr Dana Schuppert and run by Mr Hans-Wolfgang Pfeifer on the functioning of the German supervisory board. The following people belonged to this focus group: † Dr Dr hc Reinhard Goerdeler, accountant and solicitor, Frankfurt am Main; Dr Michael Hoffmann-Becking, solicitor, Dusseldorf; Dr Wolf R. Klinz, deputy chairman of the board of Lurgi AG, Frankfurt am Main; Dr Heiko Lange, member of the board of Deutsche Lufthansa AG, Frankfurt am Main; Dr Frank Niethammer, president of the Chamber of Trade and Industry, Frankfurt am Main; Dipl.-Ing. Dr-Ing. Eh Hermann Franz, chairman of the supervisory board, Siemens AG, Munich; Dr Guido Sandler, personally liable shareholder Dr A. Oetker, Bielefeld; Dr Horst Teltschik, member of the board of BMW AG, Munich; Rüdiger von Tresckow, Palm Tresckow & Partner, Frankfurt am Main; Dr Udo N. Wagner, member of the board of ABB AG, Mannheim.

I would also like to thank Professor Dr Hans Siegwart for reading the manuscript with the critical eye of the business manager and experienced administrative board member, and for his valuable suggestions. My thanks also go to Ms Ruth Blumer for her typing, and to Mr Hans-Wolfgang Pfeifer for his patience. He could not believe the number of manuscripts passed to him. I would also like to express my special gratitude to Dr Dana Schuppert, who ensured with such kindness and determination that I actually started and finished this book. She performed her task of coach judiciously and efficiently.

Terminological Aspects

The discussion about corporate governance over the past ten years has been strongly influenced by the juridical perspective. At the time when corporate law in most of the highly developed countries came into existence, one knew actually little about corporate management. This fact dominates the legal standards and how to deal with them until today. Particularly the latest reforms, which have been implemented under the influence of the corporate governance debate – and above all under the pressure of corporate governance scandals – show how little modern knowledge about management has been incorporated into legal reforms.

I wrote this book accordingly from another standpoint, namely, from the perspective of management. Only when the question of what is effective and good business leadership is answered can a comprehensive body of legislative norms within the framework of the general legal system be created. One of the many results of this book has been hereby proven: that effective management is possible under all current legal systems as they developed, as different as they may be, especially when one compares the Anglo-Saxon and the German laws.

Proper management does not depend on the technical terminology within the individual legal systems. I have therefore not paid special attention to the question of terminology and intentionally use general concepts, based on German usage, throughout. Nevertheless, the English-speaking reader may find the following definitions helpful:

Top management: The highest leadership organ or body, including both the executive and supervisory bodies together, independent of any particular juridical conceptualization.

Corporate governance: The institution that oversees the managing executive body of a corporation to ensure that the latter is fulfilling its mission and running effectively vis-à-vis internal and external factors. This term is used interchangeably with *governing body* and *supervisory body*.

Executive body: In the German joint-stock company (AG), the board of managers (*Vorstand*) in its entirety; in the company with limited liability, the top managers (president, chief executive officer, chief financial officer, etc.) as a whole. In other legal systems there are other combinations between the executives and the advisory board.

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Supervisory body: In the German joint-stock company, this is the advisory board (*Aufsichtsrat*), also referred to here as the *governing body*. It is comparable to the Anglo-Saxon board of directors. In other legal systems there are combinations between executives and the advisory board.

Chairman of the governing body: In German, the chairman of the supervisory board (*Vorsitzender des Aufsichtsrates*), comparable to the chairman of the board in English. Under German law there is no connection between the chairs of the executive and supervisory bodies, as there is between the chairman of the board and the CEO.

Board of managers: In German this is the *Vorstand*, or executive board. These managers fulfil their duties as a collective, and their liability is collective as well, regardless of their internal organisation.

Chairman of the board of managers: There is no comparable position in the Anglo-Saxon community; the best parallel would be the CEO. The German *Vorsitzender des Vorstands*, however, is not at all related to the CEO, even though that is often claimed on business cards and other documents. The realm of powers of the CEO are large, nearly limitless; those of the chairman of the board of managers are very small. He leads the meetings of the board of managers and coordinates the domain of the *Vorstand*; he is however not the superior of its members and has no supervisory authority over them. The members are appointed and recalled by the so-called governing body (*Aufsichtsrat*). Disciplinary questions are handled by the supervisory board, in most cases in a committee.

New Introduction to the Third Edition

1. Fundamental Reorientation

Economies, business, and management – and consequently society – are in a phase of fundamental reorientation. At the heart of this is the question of correct corporate governance and, in a wider sense, correct institutional governance.

In my view, the need for rethinking is a result of two widespread errors: first, that of seeing shareholder value as the sole and supreme aim of business activity, particularly for large companies; and second, that of a totally misunderstood liberalism that would not survive a moment's scrutiny by any of the great liberal thinkers. Neither of these things can be reconciled with successful corporate management, with a sustainable economy, or even with a society that works. It is my belief that in this book I have laid some of the most important foundations for the reorientation that is needed, for the correction of mistakes, and for the correct management of companies – and thus for a reordering of business and the economy.

In so doing, I provide arguments that can be used by those who find – as I did from the very beginning – that there is a good deal that is mistaken and dangerous about the way in which economies have been developing recently, and about much of the thinking on the subject and the theories relating to business and the economy. These people are generally not youthful rebels against globalization, because that is not the heart of the problem but one of its rather less significant, attendant phenomena. From the many seminars I have held and lectures I have given on the subject, and from the subsequent discussions, I know that there are a remarkably large number of high-ranking managers in business and politics who have been concerned about the trend for quite some time now. What is termed the prevailing doctrine is really more of a fashion of the day put about by the media, and it is certainly not the case that it is accepted, uncritically, by a majority of the people who every day have to deal with the realities of managing large companies and who bear the burden of responsibility. In most cases, they simply do not have the time for long discussions, and quite often they are not acquainted with the basic theories and so lack the arguments they need.

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It is to them that I dedicate this new edition of the book. In so doing, I am not ignoring or glossing over the fact that there are many top managers who willingly and unquestioningly adopted the new creed, disseminated it, and followed it. It could not have been applied otherwise. Not a few of them, and the companies they manage, now find themselves beset by major problems – as was foreseeable because it was all preprogrammed. Inevitably, however, the damage goes well beyond the area directly affected by these people. Those who are affected far outnumber the perpetrators. The fact that this book is already appearing in a third edition may well be an indication that there are a growing number of people who ponder things and apply some critical thought to them.

Not only is the time ripe for a fresh discussion, but the circumstances are favorable for one. There are unmistakable signs that views that have been considered new and, in some cases, absolute and final truths since about the mid-nineties are, in fact, questionable or have proved to be quite simply wrong – to be false doctrines. Since it became impossible to ignore the new, unexpected, and adverse realities of the economic situation and financial markets, views that once were advanced as a matter of dogma are beginning to be weakened. The financial analysts have gone quiet; the terror they were able arrogantly to exert for a few years – on the basis of their supposed infallibility – has lost its hold. People are realizing that the financial and non-financial economies were being confused, to disastrous effect. The illusion of unending bull markets and the euphoria over the New Economy are proving to be what they always were – a lack of any real understanding of economics, though beautifully packaged in all the glamour of the zeitgeist, ignorance of the history of economics, youthful inexperience, quite often sheer economic stupidity, a gambling mentality, a confidence trick, and occasionally just plain corporate crime.

A fundamental discussion on the subject of the reorientation of entrepreneurial and managerial thinking and actions – particularly for large companies – will not only be almost inevitable but should indeed be actively sought by those who are interested in having a free society, a free enterprise system, and an economy that is controlled, wherever possible, by markets. This discussion must be sought and actively organized by those who support the establishment of a true rather than a false liberalism and who do not wish to leave the field free for the ideologists – whether of right or left or of some entirely new kind. It will be necessary to hear the voice of those able to see the real danger of a new hostility to business arising from the disappointment of illusory expectations and who know how important credibility is, particularly that of top managers of businesses. Trust in them, in the conviction they carry, and in their personal integrity seems to me even more important than trust in politicians, and all the more so as the number of reports of sometimes scandalous failures in business grows – be they entrepreneurial or personal failures, insider dealing, the manipulation of balance sheets, or excessive personal enrichment.

There is a view, and one that stirs up a lot of emotion, that business is too important to be left to entrepreneurs and managers. If, as can be expected, this opinion comes back into fashion, then it will be necessary for those who set more store by having the better arguments than by showing mistaken loyalty to colleagues to intervene in the discussion. It will then take courage to stand up and be counted, courage backed by better knowledge of the subject to say that business must not be left to the "bad" managers and the "incapable" entrepreneurs.

2. What is Corporate Governance? The Consequences of Asking the Wrong Question

When this book was being written, corporate governance was not a subject that everyone was acquainted with. It was not yet marked by the one-sidedness that then set in, which was accepted largely without criticism and which saw the company and its purpose solely from the point of view of the financial economy and in the light of the interests of the stock exchange, the analysts, the fund managers, and other players on the stock exchange.

A typical case of this one-sidedness and one that is representative of many similar examples is a hash of numbers claiming to be a study, which was carried out by a firm of consultants on behalf of a major German magazine. In it, the Euro Stoxx 50 shares were rated by two hundred fund managers and analysts according to the criteria: shareholders' rights, quality of the supervisory board, takeover barriers, transparency, and commitment to shareholder value. The verdict they gave – as it always is, in contrast to what happens in America – was one that was devastating for the European companies. However, except for "quality of the supervisory board", the criteria for the assessment had virtually nothing to do with the companies' actual ability to perform or their competitiveness. This kind of one-dimensional understanding of corporate governance is blind to everything else and therefore obviously misses what it should really be examining: everything is rated but the company itself. Among the companies that were rated in this way were ones that were clearly superior to their American competitors, but this did not strike the self-styled experts making the ratings. The value of so-called studies of this kind is clear.

The origin of this trend lies in the fact that the wrong question is being asked. When one asks, "In whose interests should a company be managed?", the easy answer is "the shareholder" and appears to be logically plausible. But appearances are deceptive. There is no logical necessity for this to be the answer, and it is not the only one that is possible. Nor indeed is it the best one. The only way in which it can appear at all plausible is under very particular conditions that occur quite rarely.

Suitable conditions were present in their most extreme form in the USA at the end of the eighties, whereas in most other countries they did not exist or were present only in a rudimentary form. Even there, they had been only artificially and temporarily implanted. Some clear examples of this were the "tiger" countries of Southeast Asia, which for a time were blissfully greeted as *the* economic future. These countries collapsed because of the artificially created conditions – namely, a financial bubble based on excessive debts – and not because, say, the conditions in question were not present.

Another example illustrative of rare special conditions, and one that took quite a long time to become apparent but is now all the more significant, is the fact that the shareholder value theory can appear to make sense, indeed can appear to be the only possible theory, only at times when share prices generally are rising, which was the case in the USA and had been since 1982. This date appears to be totally unknown to the majority of those who, in the nineties, began to be active on the stock exchange and who related what was happening on the stock exchange to the prosperity of the economy and the performance of companies – in some cases by using grotesque theories about the rationality of capital markets and their superior wisdom in the matter of assigning value.

This phenomenon, combined with illusions about the New Economy, finally led to a short-lived mass frenzy of speculation of the kind that has occurred time and time again in the history of economics, albeit at fairly long intervals. These intervals are sufficiently long enough to allow the unpleasant experiences to be forgotten and the lessons that should have been learnt to be pushed aside with the words "it's all entirely different this time". What the "New Era" was in the first twenty years of the twentieth century, the "New Economy" was in its last twenty years. Lazy journalists could take their headlines straight from the *Wall Street Journal* or the *New York Times* of the day without changing a word.

It is, of course, absurd to assume that stock exchanges only ever rise – though it was precisely this absurdity that determined people's thinking and actions. And it is equally absurd to base corporate governance on this assumption. Although the idea was mistaken even before this time, it is the advance of the bear market that really shows its complete worthlessness.

Where the shareholder value answer has the greatest apparent plausibility is in the context of the large groups of companies operating on an international scale that are quoted on the stock exchange *and whose shares are ris-*

ing. However, in the first place, even there the plausibility is only apparent; there is no real logic behind it. In the second place, such large corporations are not representative of the economy generally; it is just that the media pay a disproportionate amount of attention to them. In all countries, the large companies make only a comparatively small contribution to the strength of the economy. They produce less than a third of the value added in the economy, and they employ less than a third of the total workforce. It is true that the corporations are important, but they are in no way typical of what happens in the economy.

The sector that attracted the attention of the masses in an almost hypnotic way ten years after the invention of shareholder value – the Internet and E-business start-up companies – is also not representative of the economy, not even of a New Economy that was proclaimed all the more loudly the less the proclaimers understood about economics. In all countries, more than two thirds of the output of the economy is produced by small and medium-sized enterprises, and it is these that employ the same proportion of the total workforce. Even with any number of well-intentioned adjustments, not only is shareholder value useless to these companies but it is also in them that its misleading and thus damaging effects become quickly and directly apparent.

Hence, a number of different answers would have been possible even to the wrong question that was asked, and it was only a very special state of affairs that produced for the shareholder value theory the sort of receptiveness that made it appear to be the only possible theory. It is one of the ironies of history that now, prompted by recent events, the initial and previously dogmatic champions of the shareholder value theory, realising that their theory is failing to deliver, are intent on a major "reform". This consists of their changing over to the "stakeholder theory", failing to appreciate as they do so that this is just another false variant of the interest group theory and clearly being unaware that it was precisely the failure of this theory in practice that gave shareholder value its coincidental plausibility and created the receptive climate for it.

No matter how one looks at it, it is never possible to get a correct answer if the wrong questions are asked. It is necessary for the questioning not merely to start one step earlier but at an entirely different point in the logic: not at the distribution of a business's profits but at the *creation* of profits. The question should therefore be: What is correct corporate management? And, given that, the other things that need to be asked are: What is a strong, healthy, and viable company? And what is it that the executive top management and the people supervising the company have to do to produce and maintain a company of this kind?

Only by managing companies correctly is it possible to achieve the economic results in the form of productive potentials, whether they are factories or computers, bricks or bytes; in the form of goods and services; in the form of national income and national product; and in the form of wages and salaries, taxes, interest, and profits.

Not until and only if an economic result has been produced is it possible to set about distributing it. And only then does the key question in the shareholder theory, namely how much should be distributed to whom, begin to make sense. It is only when this point has been reached that it makes any sense to consider which of the various interest groups, whatever their claim to legitimacy, are to receive what share of the economic result. At this point, there may then be perfectly good reasons for giving the shareholders preferential treatment.

3. Misconceptions and Their Consequences

What I therefore suggest as the central question in corporate governance is an entirely different one from the shareholder value theory and one that is directed at the origin rather than at the distribution of what economic performance produces. Generating performance is the difficult part of business activity; distributing the results is easy.

If the questions that are asked start with the interests of the different interest groups, they turn the company into a football on the playing field of changes (which are sometimes swift) in the amounts of social and political power of the groups – and thus potentially destabilize it. The questions that I suggest above for corporate governance to ask, which are both entirely different and also far more comprehensive, do not do this but cause the company itself to be seen as a productive unit, a unit that is all the better at creating a standard of living and prosperity the better it works – with no reference whatever to specific interests that interest groups have. What the top management bodies should take as the deciding criterion for their actions should be not the best balance of interests of interest groups but the best interests of the company. Alfred Rappaport never considered a solution along these lines.

This perspective is focused on the *non*financial side of business activity rather than, as shareholder value does, on the financial side. The shareholder value theory combined with the boom on the stock exchange produced confusion between the two sides of business activity, the nonfinancial economy and the financial economy. The inevitable consequence was thus confusion, too, between the entrepreneur and his entrepreneurial task, on the one hand, and the investor and his entirely different task of investing money, on the other.

Both are necessary; both perform important functions in a modern-day economy. But they follow an entirely different logic. The relationship between the nonfinancial economy and the financial economy used to be clear: the purpose of the financial economy was to provide finance for the nonfinancial economy. Up until about the late eighties, the volume of finance was therefore a stable proportion of the flow of world trade and of worldwide investments. After that, the two economies developed in such different directions that they literally had to be considered two different economies. They each have their own, but entirely different laws, logic, time scales, and reasons for acting.

They are so different, it happens time and time again that representatives of the two economies completely fail to understand one another, because they are talking about two different worlds. As I explain in this book, that is one of the reasons why I recommend caution when it comes to appointing bankers to the supervisory boards of companies operating in the nonfinancial economy. They are very good as experts on finance, but they have only a limited understanding of the nonfinancial economy. To adapt slightly something that Peter Drucker once said, and that was perhaps something of an exaggeration: bankers understand everything about money but not much about the economy.

There are, therefore, hardly any cases in which a banker has been successful in managing the operations of an industrial company. And companies have regularly got into difficulties when people in finance, experts on balance sheets, accountants, treasurers, and controllers have reached the top positions in them. Daimler-Benz in the days of Reuter is one example; Swissair in the days of Bruggisser is another. It might be more than just coincidence that Rappaport, the inventor of shareholder value, is a specialist in accounting, and that auditing firms were particularly fascinated by this theory and spread it around through their consultancy departments. It should not be forgotten that accounting companies did not expand into the field of general management consultancy because they had any particular expertise in the field but simply for reasons of economic survival. The problems created were not just the clashes of interests that thus became inevitable – the case of Enron is just one example – but also the questionable expertise they had in matters of strategy and management.

This aspect might turn out to be one more proof of the claim made by the man who was perhaps the greatest expert on corporate strategy, Alois Gälweiler[1]: that a company cannot be managed with the information that ac-

[1] See A. Gälweiler: *Strategische Unternehmensführung,* 2d edition, Frankfurt/New York, 1990.

counting provides. That however is precisely the illusion that the "bookkeepers" have, and they try to show how right they are with impressive, complex formulas. Any improvement in accounting is welcome, of course, and I entirely agree with Rappaport when, right at the beginning of his book, he levels some criticisms at the shortcomings of conventional accounting. However, his more far-reaching reflections do not go beyond the confines of accounting and certainly not into the realm of corporate strategy[2]. There is one thing above all that the tricks of accounting do, and it is by no means in the best interests of correct corporate management: they lull managers who are not sure of themselves into a mistaken sense of security. That some academics in the fields of economics and business administration showed great energy in helping to provide this wrong thinking with "scientific" sustenance, is perhaps attributable to a lack of practical experience. What may not have been necessary though was quite the amount of servility that was observed being shown to the media and to analysts.

A major factor in encouraging the swift spread of the shareholder value concept was probably the belief that it was possible to calculate in places where in fact judgment and experience were necessary. Strategic management and corporate governance start where accounting, even of the most sophisticated kind, necessarily has to stop, because there is no way in which the really crucial questions in corporate management can be quantified in monetary terms.

Every time in history that money has been confused with business, whenever the financial economy and its logic (generally due to chance circumstances) have assumed a dominant position and have influenced people's thinking and actions for any length of time, the result has been the opposite of what was put forward to promote and justify thinking directed towards the financial economy: not a flourishing economy showing rugged expansion and a steady build-up of value, but financial markets careering out of control due to excessive indebtedness, followed by collapse and a phase of economic contraction and deflationary destruction of value. In history, the result has always been not prosperity for everyone but poverty for many – which, in some cases, gave rise to a period of political radicalization and totalitarianism due to a widespread loss of confidence in the ruling institutions.

I am talking explicitly here about a *deflationary* destruction of value and not the danger of inflation that is so often cited in particular, of course, by

[2] Incidentally, Rappaport's reflections also fail to take him beyond the point that German-language business administration had already reached in its theory of the valuation of companies, as Horst Albach has conclusively demonstrated. See H. Albach, "Shareholder Value und Unternehmenswert" [Shareholder Value and the Value of Companies]; in: *Zeitschrift für Betriebswirtschaft*, vol. 71 (2001), pp. 643–74.

the central banks. It is not the destruction of the value of money that is the result of collapses of this kind in the financial economy but the destruction of values in the nonfinancial economy by way of the falls in the prices of shares, declines in the price of real estate, and drops in the prices that can be charged for products and services. Company turnover and people's incomes go down, economic caution becomes the watchword, and a deflationary spiral gets underway; and unfortunately there is no central bank policy that can help the economy to get out of it.

A society that is functioning properly needs companies that are prospering. Maximizing the productive power of companies in *real* terms is what creates real value as opposed to financial value; it provides the things that improve peoples' lives in real terms, namely more and better food, clothing, and living space; more and better education and training; more mobility and communication; more and better leisure; and more and better art and culture. That is what a standard of living and prosperity mean. Contrary to a widely held view, these things are not achieved through increases in financial value, let alone through speculative financial bubbles that divert economic resources away from the creation of real prosperity and channel them into the stock exchanges. For a time, it may look as though more and greater values are being created there. But what in fact are being created are the conditions for a destruction of values that will last even longer.

4. Corporate Governance in the Service of the Company

From the point of view of the management of a company, regarding the creation and increase of its productive ability to perform and its success in the market place, my suggestion is that attention is focused not on any of the possible interest groups, on either the shareholders or any other so-called stakeholders, but on the company itself. The term used for this concept in the book is "corporate capitalism", as opposed to "shareholder capitalism" or "stakeholder capitalism".

Looked at in this way, the company is not a toy for a bundle of interest groups to play with but an institutional unit in its own right, namely the archetypical, productive entity in a developed society. To the legal mind this is a familiar concept; it was not for nothing that the joint stock company was constituted in law as an artificial person in its own right. It also has to be said that what is good for the company will, because of the need to remain flexible, always lead to victims among particular, even temporarily all, interest groups. I suggest taking as a point of departure the fact that a company is not there to satisfy interest groups but to produce an output for the market. That, of course, is not a law of nature, and there is nothing to compel anyone to accept my suggestion. Whatever approach is considered a decision has to be made, and it should be the one that is most likely to lead to the company being managed correctly.

Seen in this way, the purpose of the company is thus neither to make shareholders rich nor, as was long believed, to create jobs. So let's not try to introduce any sort of vague social responsibility, as other critics of shareholder value do repeatedly. This line of argument has been contradicted by experience with the welfare state. However, a company that is prospering will always be sufficiently able to satisfy the interests of interest groups and perhaps, above all, those of the shareholders. As was mentioned at the beginning, particularly anyone who is interested in a working, free-enterprise system and a market economy capable of operating successfully in the long term has to accept the arguments that support this logic.

This reasoning turns the spotlight onto the key question: When does a company prosper and how should it be managed so that it does prosper? The answers can be found in this book, and they are confirmed by the way in which the world economic situation is developing. From an operational and strategic point of view, a company does not prosper when it is oriented towards shareholders and the stock exchange scene but when it has *customers* who will pay for the things the company can do for them. The purpose of a company should therefore be seen as creating customers. If the creation of value is to be an important consideration (which it does not in any way have to be), it is customer value and not shareholder value that should be the constant and consistent guiding star for corporate management. That principle – and that alone – will maximize the chances that the right decisions, namely market decisions, are being made consistently. But it does not in any way guarantee that right decisions will be made. No such thing is possible. As I show in this book, there are a number of factors – at least six – that have to be taken into account, *all at the same time*. This consideration seems to be one of the most demanding, and it is clear that it is followed, time and time again, by a search for the one, the only, the ultimate guiding principle. But corporate management is not as easy as that. However, anyone who has customers will always find providers of capital and, in the end, will also have satisfied shareholders and stakeholders – not as the aim but as a consequence of doing business successfully. Top management and the executive and supervisory bodies should be set up accordingly and placed under an obligation to follow this principle. And they should be appointed, assessed, and rewarded in light of it.

One can object that what is in fact being done here is simply recommending the stakeholder approach again, because customers too are one of the possible interest groups. Seeing customers as an interest group would, however, be completely wrong and would ignore the totally different logic by which customers and interest groups operate. This is one of the mistakes that Rappaport himself makes.[3] Customers do not have interests; they pay for a product or a service. If this company fails to provide them with the service, they will go to another one. They do not rely in the least on interests and on safeguarding or asserting them. Customers only become an interest group when there is no competition, when companies are in a monopoly position, when, as a result of the change from customer to interest group, the most important attribute of a customer is missing, namely the ability to choose, the ability to say no. The logic by which the customer operates is based not on interests but on the benefit he gains, on the value he gets for his money compared with what the available competition would give him.

This also shows that, because of the shareholder value theory, the basic question of corporate strategy has been misunderstood. The logical consequence of shareholder value was what were termed value-adding strategies, that is, adding value not for the customer but for the shareholder. Such strategies were aimed at the market, meaning an increase in value on the stock market.

It is not, however, a purpose of the company to be valuable. That cannot even be what the shareholders are aiming for – except when what they are really interested in is not the company but only in the securities that give evidence of the ownership of the company, the shares to be exact; and when they confuse the shares with the company. This is why there is never, in any of the articles of association by which companies are founded, a sentence that says something along the lines of "a company limited by shares is hereby founded, whose purpose is to be valuable". The definitions of purpose in the articles of association are different from this; they say, for instance, that the company's purpose is "trading in goods of all kinds" or "the conducting of banking business" or "the production of computer software, or automobiles, or machine tools".

The purpose of the company must be to be *competitive* in its field. That is not at all the same thing as being valuable. A company is competitive when it can do what the customer pays for better than other companies. For this very reason, the logical equivalence is to say that the purpose of the company is to create *satisfied* customers. As mentioned above, the creation of jobs cannot be the purpose of a company nor can the creation of shareholder value. The purpose of a company should be directed at creating customer value. Of course, contrary to the occasional objection, this does not mean that the company's products and services have to be given away. In

[3] A. Rappaport, *Creating Shareholder Value*, rev. edition, New York, 1998, chap. 1.

business, the term “satisfied” can logically only ever mean “relatively satisfied”, that is, making the customer more satisfied than the competition can. There are passages where Rappaport takes a very similar view[4], but his counterarguments in this connection[5] and the example he uses are not conclusive. On this very point in fact, they lead to a false conclusion, because his whole thinking is based on the wrong central question. No one of course is making any sort of plea for customers to be subsidized until the company is bankrupt. He is quite right when he says that customer value does not automatically change into shareholder value. No one ever claimed that. There are no automatic mechanisms of this kind; but just the same, there are none the other way round from shareholder value to some other value.

There is no causal relationship between the value of a company – no matter how it is defined or determined – and its competitiveness. As even the most unperceptive can see from the stock exchanges, now that the climb to stratospheric heights are over, the very thing that is not possible is to infer the competitiveness of a company from the value of its shares. At no time in the history of economics was this ever possible. If the inference is made, all that can be seen is the naivety, greed, and anxiety of the investors. Conversely, although there may be a relationship, there does not have to be one. The cause-and-effect relationship between competitiveness and the value of the shares is in no way absolute, a fact the excessive valuations of the past few years have provided impressive proof of.

Unlike the shareholder, the customer does not pay for the value of the company; he pays for the value of its products or services. That is a value neither of the company nor to the company. It is a value to the customer. What in his eyes is valuable to him and solely to him. It is what he pays for, and that is the only reason why he buys anyway. Whether the purchase in question adds to the value of the company is totally immaterial to him.

The value of the company is important only to people who are not managing it. They do not want to operate it but instead want to buy or sell the company as a whole or parts of it. Hence, for the entrepreneurial activity of the company itself – the actual doing of its business – the question of its value simply does not arise. But the urgent and unrelenting question that does arise, and arises afresh every day, is that of its ability to perform and its competitiveness.

A point that should be remembered here is that one of the main areas in which shareholder value and its arithmetical determination were applied was not trade *for* companies, or rather for their management, but trade *in*

[4] Such as when he says: “Even the most persistent advocate of shareholder value understands that without customer value there can be no shareholder value. The source of a company’s long-term cash flow is its satisfied customers.” Ibid., p. 8.

[5] Op. cit.

companies – which happened in connection with the wave of mergers and acquisitions that really got underway in the second half of the eighties. What is involved here, as can easily be seen, is a confusion between the purpose the shareholders have in mind and the purpose of the company, and a highly questionable equating of the one with the other. As I mentioned above and as can be clearly seen again here, though from a different point of view, there is also a dangerous confusion between what is today referred to as an investor and what is meant by an entrepreneur, which also includes the entrepreneurial manager. There is a fundamental difference between the interests of the investor and the entrepreneur, as well as between the logic of their situations, as is readily apparent from the fact that although every entrepreneur has to be an investor, there are only a few investors who are entrepreneurs.

My suggestion that the company itself and its prosperity be made the primary focus of corporate management is not made in any anti-profit-making spirit, quite the reverse. As can be seen in chapter 5, this approach tends to produce a greater requirement for profits than the shareholder approach. Above all, it produces requirements that arise from the operation of the company and not from the arbitrary demands of shareholders or, as experience shows, not infrequently from pure greed on their part encouraged by the analysts. And what is even more important, the company-based approach produces genuine profits, not the sham profits resulting from creative accounting and balance sheet formulation to which the shareholder approach leads with inherent inevitability, particularly in times of a booming stock exchange. Of this, too, there has been plenty of experience.

Of course, the company has to cover the costs of its capital and has to make a profit on top of this. It does not follow from this that doing so is its purpose, not to say its sole purpose. No one will deny that people have to eat. However, it cannot be inferred from this that the aim and purpose of human beings is to eat, and anyone who defines his own personal aim and purpose in this way (as everyone is free to do) is hardly likely to be satisfied with the consequences.

5. Illusions

The shareholder value theory has taken firm root in the brains of the bulk of a generation of youngish managers, journalists, analysts, consultants, management trainers, and scientists as the only possible avenue to reasonable corporate management and business activity. Because they have never experienced anything else, they naturally interpret everything in the context of the bull market on the stock exchanges and are unaware that because of this they know only half the truth about the stock exchange, the agreeable half. They have not yet experienced a bear market; they do not know how brutal it can be, how long it can last, and how far share prices can fall, or that, in history, after every boom there has always been a slump that took prices back to or below the level they were at the start of the boom. These people have never known or experienced anything other than shareholder value and a boom on the stock exchanges. They are not aware of any alternative. They do not know why, in fact, this theory came into being at the end of the eighties or the situation and historical trend that it resulted from. They therefore consider this theory to be the only conceivable truth – and defend it with dogmatic stubbornness in the same way that half-truths have always been defended throughout history.

However, as has been explained, the shareholder value theory is by no means the only theory. For this generation it was simply the latest theory – and it is possibly the worst. The doyen of writers on management Peter F. Drucker expressed his doubts back in the early nineties and has repeated them on a number of occasions since. My own skeptical attitude is set out in detail in this book. I consider this theory to be wrong and misleading and essential parts of it to be dangerous inasmuch as following them will have severe adverse consequences for business and society. It is not the case, as is often claimed in discussions, that shareholder value has not been correctly understood; it has not been wrongly understood but is in fact *wrong* – namely as a guiding principle to orient entrepreneurial and managerial actions in the long term. It is hostile to innovation and leads to resources being misallocated.

As mentioned, that in itself need not be a compelling reason for managers and supervisory bodies to reject shareholder value. In a free society, anyone is free to opt for this or that theory – even for one that is wrong. However, in order for a choice to be reasonable it should be made with a knowledge of the theory's consequences, and in the light of the available alternatives and their consequences.

Among the inevitable consequences of an orientation to shareholder value is the temptation for managers to do everything possible to make the company look profitable, even when it is nothing of the sort. Included here is pampering the public by raising their expectations, showing pro forma profits when there are no longer any real ones, massaging the balance sheets wherever possible, and spending all the reserves on the stock exchange, simply in order not to disappoint the expectations they have nourished themselves.

As explained, it was not only the case that it was purely under certain chance conditions that the orientation to shareholder value could gain any sort of footing, but in conjunction with the biggest bull market in history and misinterpretations of the economy and economic activity, a convincing mix was produced that for many people took on the character of a cult, one that was frequently defended against any doubts not with arguments but with aggression. This was something I experienced myself on a number of occasions, most flagrantly in the case of a member of the top management of a German electronics company, which was making one of the most noted and apparently most successful public offerings in the days when the boom was at its height. The man showed all the signs of the shareholder philosophy in a particularly marked form, and not only was he unable to get anything out of the thoughts I expressed but absolutely failed to understand what I was talking about. There was a large audience but he made no attempt to conceal the aggressiveness with which he dismissed my ideas and let me hear and feel what he thought of them – which in the eyes of most of the people present did not say very much for the standard of his upbringing. Basically, though, he was merely to be pitied. Today, not only are his share options worthless, not only has he thus worked for a number of years in effect for nothing; he is also mired in insoluble financial problems because, in a big way and on credit, he bought shares in his own company and, trusting blindly in the spirit of the times, in other "high tech" companies with "high potentials".

Some of the most erroneous developments in the history of economics came about as a result of this cult, and they led to the structural weaknesses that are becoming ever more clearly apparent in the American economy and, due to unthinking imitation, in many other economies, too. It is quite possible that the nineties, particularly the second half of the nineties, will go down in the history of economics as a period of collective errors and mass delusion.

How could a cult-like phenomenon of this kind come about? The reason was not just the shareholder value theory with its superficial logic and plausibility but also that it coincided with certain other factors in a combination that, though not unique, is certainly rare. The most important of these factors is what was considered the spectacular economic miracle in America. This miracle followed on the heels of a recession in the early nineties, which was indeed serious but only brief compared with other countries; and it was supposedly brought about by the clever economic policy of the US, above all the policy of the US Federal Bank, and by the great performance ability of the shareholder-value-oriented management philosophy of Corporate America. The second factor is the longest bull market in the history of the stock exchanges, which appeared to be the result of the first factor and to be carried along with it – and in which any fall in share prices was nothing but a good opportunity to buy. The third factor is the belief in a globalization that would suffer no setbacks and would ultimately be to everyone's benefit. The fourth factor is the theory that digitization and the Internet would result in an economy that was not only new but also sheer paradise in every way. On top of these is the fifth factor – perhaps the most effective of all in spreading such beliefs quickly: an unprecedented propaganda in the media purporting all these seemingly so new and desirable phenomena.

6. Entertainment Rather than Information

One important thing during the boom was – and still is – the gulf between the economic facts and what the media reported (and still report) about the economy. The two have almost nothing in common. As I have repeatedly said in many of my publications, and particularly in my monthly newsletters on management, there has always been a certain discrepancy between the economy as portrayed and the economy as real. However, except in the twenties of the last century, this discrepancy has never been so wide as it has been in the past five years, and never has it been nurtured with such professionalism, and hence so effectively.

The reason for this is not a decline in the quality of the classic newspapers and magazines in the field of economics and business on par with the *Neue Zürcher Zeitung,* the *Frankfurter Allgemeine, The Financial Times,* or *The Economist*. These publications are just as good as they ever were; they are also just as dry and, in many people's eyes, "boring". It is therefore not from them that the public gets its information but from the new *popular* business magazines, as they might be termed.

These magazines have turned the economy into a forum for entertainment. Their aim is not to inform but to create a good atmosphere. This new economic show business is intended above all to be a business, and the only way of doing that is with optimistic reports. The old newspaperman's saying "Only bad news is good news" turns into the opposite. No one wants to hear bad news about the economy and certainly not about the stock exchange.

This development has produced an unholy alliance with the sales interests of the Wall Street industry, which can use this new media vehicle to put itself across to dazzling effect. This is true of many printed publications but it is particularly clear in the case of television. CNBC can be cited as a representative of the genre. It is difficult to imagine that the professionalism – and hence the effectiveness – of this TV station could be surpassed. The direction in which the reports tend is unmistakable – bullish, bullish, bullish; optimism, calculated optimism, euphoria. It is impressive how skillfully a positive spin is put on even the most negative facts and events – such as spectacular bankruptcies, business crime on Wall Street, and slumps in companies' profits – without, it is true, any relation to reality (except the psychology of greed). But outstandingly well done from the media's point of view.

However, as a result of the mismanagement caused by the false theories of the nineties and the misallocation of resources based on it, the economies of many countries, above all that of the USA, are in a state which makes any swift and sustained recovery unlikely. Believers in the almost universal idea that what is involved is a short-term, so-called "V-shaped" recession are likely to be bitterly disappointed, for reasons which are of a structural nature.

The first and perhaps most important of these reasons is what might without exaggeration be described as the implosion of profits among the big US corporations. That has never happened before in the history of the US economy. The reason for it is simple: previously, profits had been massaged as far as they could be without actually falsifying the balance sheets – in obeisance to the shareholder value cult and out of servility to the analysts. A second reason is the excessive indebtedness among companies and private individuals, something else that is unparalleled in history. A third reason is a flagrant weakness of investment of a kind that, once again, has never happened before.

There are, though, many people who refuse to face up to the truth, in the same way as there were people who were unwilling to admit there could be a recession – even at a time when, as is now being confirmed in retrospect by the US authorities responsible, it had already begun. People thought that cyclical ups and downs were now impossible. To illustrate the general view, I will mention here a report that appeared in the *Wall Street Journal* in June 1998, in which the MIT professor of economics Rudiger Dornbusch was quoted: "The U.S. economy likely will not see a recession for years to come. We don't want one, we don't need one, and, as we have the tools to keep the current expansion going, we won't have one. This expansion will run forever." Dornbusch is not just "anyone" but one of the leading opinion-makers, lecturers, and commentators.

The economies of other countries too, which for quite some time, in a mood of euphoria and with no attempt at differentiation, were hyped up and presented as new paradises, are in desperate straits: the countries known as the Asian tigers and the majority of states in Latin America. What the position really is in India and China is only possible to guess; there is little that can be known for sure because the figures are notoriously unreliable.

7. Appearances are Deceptive

Anyone who made a sober analysis of what was happening in the economy, particularly in the USA where the aberrations of the past few years originated, soon came to the following conclusions, which month after month were confirmed all the more clearly:[6]

The much praised and naively admired American economic miracle never happened. It was a media event and nothing more. In particular, the American growth rates, even in their official, published form, were in no way higher than in earlier periods, as a comparison with any time since the Second World War will show. In addition they were massively inflated by the statistical effect of "hedonic price indexing". The authorities responsible have now begun to make retrospective downward corrections to the figures, although of course nobody is taking any notice of that fact.

There never was any productivity miracle, except in the small sector of computer manufacturing. Professor Robert Gordon of Northwestern University in Chicago is one of the few who have made a clear-sighted analysis of the published figures for productivity. As he has shown, there was not and is not any quantitative evidence of the claims that were made of rising productivity.

The American profits were attributable predominantly to creative accounting and the massaging of balance sheets and not to any real economic performance. They arose first from stock options and from the wrongful entering of the tax advantages resulting from them; second, from expenditure on software being shown as an asset rather than being immediately written off; third, from the low salaries that were part and parcel of the stock options; and fourth, from maneuvers on the financial markets, such as the schemes for buying back shares.

The stock exchange boom was never based on any genuine value added but on the exorbitant indebtedness of all the sectors of the American economy. Even the much-praised American "budget miracle" never happened. America's public indebtedness is still rising, and today it is greater than it has been at any time in the past.

The majority of American figures relating to the economy for the past five years are incorrect or have been wrongly interpreted, and have as such been spread by the media. The actions people take have thus been steered in the wrong direction, and this in turn has resulted in a massive misallocation of resources. Now that the illusion of a steady upward trend in economic activity has had to be abandoned, a need for massive corrections, which will take a long time to complete, is arising.

[6] See the appendices at the end of this book.

The view that the American economy is so successful because of its particularly good management and its advanced corporate governance is wrong – and it can be seen from the current corporate insolvencies and their consequences that corporate governance of this kind is unable to exert any effective control on the management, either in the service of the company or – ironically enough – in the service of the shareholders. Despite what is claimed to be, in comparison to Europe, the progressiveness and superiority of American corporate governance, with all the transparency it calls for, shareholders' rights and other safeguards, there are still dramatic bankruptcies in the USA, as is proved by the case of Enron, which will not remain an isolated incident. And despite what is claimed to be our backwardness in Europe, we do have some companies whose management is a model of what management should be, as can be seen by studying Nestlé, to take just one example.

There are, in fact, well managed and badly managed companies in all countries, regardless of the rules about corporate governance. I do not, of course, have anything against a reasonable legal basis for the management of companies. But laws and rules will not enforce good corporate governance or prevent the bad sort to the degree that their supporters claim. To a far greater degree, the key lies in the expertise of the top management bodies, as well as that of the executive and supervisory officers and in the way they work. If a supervisory body does not work or works badly, there is nothing that can compensate for that.

The belief in the fundamental and universal superiority of American management practices is therefore just as naive as was the belief in Japanese superiority that prevailed from the mid-eighties to the early nineties. The US economy has many strengths that the European and Asian economies do not have; but it also has its weaknesses. It should be imitated at the points where its strengths lie. Contrary to the widely held view, corporate governance in particular and management in general is not one of these. People with experience saw that right from the start and acted accordingly.

Entrepreneurs and managers will have to adjust to the fact that a fundamental reorientation is needed. This will consist in thoroughly freeing oneself of the high-flying ideas of the nineties and preparing oneself for times when the climate is harsher. A robust, customer-oriented business strategy, uncompromising improvements in productivity, professional management of innovation, the eradication of illusions and bragging from all parts of the company, a level-headed examination of the boasts about anything with an "E-" in front of it, and performance and accountability at all levels – those are the most important reference points for people to orient themselves towards over the next few years. Bluffers and confidence tricksters should not be given a chance in companies. Companies had people like that, plenty of them, in the nineties. Now it is real substance that should be demanded again.

Competent managers are immune to the comings and goings of fashions, and mentally they are unaffected by the spirit of the times. They are masters of their managerial craft. They represent the models of a new modesty and sobriety that are better able to mobilize the willingness of the people who are necessary for the reorientation to be successful than the visions and illusions that led to wrong expectations and false hopes.