Capitalism

Capitalism's enemi

By Robert J Samuelson

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AMID the mayhem on world financial markets, it is becoming clear that capitalism's most dangerous enemies are capitalists. No one can have watched the "subprime mortgage" debacle without noticing the absurd contrast between the magnitude of the failure and the lavish rewards heaped on those who presided over it. At Merrill Lynch and Citigroup, large losses on subprime securities cost chief executives their jobs - and they left with multimillion-dollar pay packages. Stanley O'Neal, the ex-head of Merrill, received an estimated $161 million.

Everyday Americans will conclude (rightly) that this brand of capitalism is rigged in favour of the privileged few. It will be said in their defence that these packages reflected years of service, often highly successful. So? It's not as if these CEOs weren't compensated in all those years. If you leave your company a shambles - with losses to be absorbed by lower-level employees, some of whom will be fired, and shareholders - do you deserve a gold-plated send-off? Still, the more serious problem transcends the high pay itself and goes to the wider consequences for the economy.

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Concentrate on the possible fallout. If banks and investment houses sustain more losses, the nation's credit system will be further wounded and so will the economy. The Federal Reserve cut its key overnight interest rate yesterday from 4.25 percent to 3.5 percent - a huge move - in part to shore up this wobbly credit system.

By "Wall Street", I mean all the commercial banks, investment banks, mutual funds, hedge funds and the like that comprise the financial sector - but particularly investment banks. Pay is eye-popping. In 2007, Lloyd Blankfein, chief executive of Goldman Sachs, received compensation estimated at $68 million. But pay is also heavily skewed towards annual "bonuses" based on the profits that traders and bankers generate. I asked Johnson Associates, a compensation consulting firm, for typical Wall Street pay packages. The results describe "managing directors" based in New York with 10 or 15 years experience. Most would be in their 40s.

Here are estimates for 2007:

Investment banker: $2.1 million, consisting of $275,000 in base pay plus $1.2 million in cash bonus and $625,000 in long-term bonus. (An investment banker helps firms raise capital by selling new stocks and bonds and also advises on mergers and acquisitions.)

Bond trader: $1.5 million, with $240,000 in base pay, $975,000 in cash bonus and $310,000 in long-term bonus.

Hedge fund manager: $1.8 million, split between a salary of $265,000 and $1.5 million bonus.

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Just why investment bankers and traders out-earn, say, doctors or computer engineers is a question I've never heard convincingly answered. Are they smarter? Unlikely. Do they contribute more to the economy? Questionable. True, Wall Street often performs a vital function. It channels savings into productive investments. It helps provide access to capital and credit. In 2006, US companies raised nearly $4 trillion through new stocks and bonds. Many financial innovations, including mortgage-backed securities, have benefited individuals and companies.

But Wall Street also frequently misallocates capital and credit. The "tech bubble" of the late 1990s was one episode. Now we have subprime mortgages. Why? Well, the herd mentality of financial crazes has a long history. But compensation practices skewed so heavily towards bonuses based on annual profits make matters worse.

"People self-select for careers. On Wall Street, they self-select for the money", says pay consultant Alan Johnson. "Wall Street is a sales business - they sell bonds, securities, transactions, ideas. They're not paid to be long-term, philosophical, reflective." The pressure is to do the next merger, sell more stocks and bonds, do more trading - whatever boosts current profits and bonuses, the long-term consequences be damned.

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"These are my MBA students, not just mine but MBAs from Harvard, Stanford, Pennsylvania", says economist Allan Meltzer of Carnegie-Mellon University. "They were buying and selling this garbage (subprime mortgage securities). Are they so stupid? They got compensated for doing it. If they didn't do it, they'd lose their jobs."

To be fair, the real estate bubble had many causes, including low interest rates, the political popularity of homeownership and the (mistaken) belief that housing prices could never fall. This may explain why, so far, the backlash against Wall Street has been muted.

But if the subprime failure turns out to be a preamble to a larger financial breakdown, flowing from the creation of new securities that offered short-term trading possibilities but whose long-run risks were underestimated, then the mood could turn uglier. Indeed, many Americans may conclude that capitalism has run amok.

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