



What is Right and Good Management?

m.o.m.[®]-Letter

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Prof. Dr. Fredmund Malik

Tides of the Great Transformation 21

- Mood and Mindset
- Constants of Change
- Creative Destruction
- Was Kondratiev Right?

Keywords: Economic Crisis, Solutions

*«Fredmund Malik is (...) the leading expert on Management in Europe.
He is a commanding figure - in theory as well as in the practice of Management.»*

Peter F. Drucker

«Fredmund Malik is one of the most influential business thinkers in Europe.»

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Prof. Dr. oec. habil. Fredmund Malik is founder, owner and chairman of Malik Management, St. Gallen. With some 300 employees in St. Gallen, Zurich, London, Vienna, Berlin, Toronto, Beijing and Shanghai, the company is the world's leading provider of wholistic cybernetic management systems as solutions for the mastering of complexity, change and dynamics of our global, interconnected systems of the Great Transformation of the 21st century.

Awards: Cross of Honour for Science and Art of the Republic of Austria;

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Foreword

In the Great Transformation 21, nearly everything is changing with regard to human action, its modes and its motivations. Psychology too will be affected, i.e. the general mindset and mood. The driving forces behind these changes are investment, innovation and substitution processes that play out in patterns, bursts and waves. Those who understand these forces will have an edge in the evolutionary struggle for survival and success in the New World Order.

In this and the next two issues of the m.o.m.® letter I will be exploring the navigation instruments and change methods managers can use to meet the great challenges of our time.

St. Gallen, in August 2010

Sincerely yours,

Prof. Dr. F. Malik



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Tides of the Great Transformation 21

1. Mood and Mindset

The Great Transformation 21 I have been writing about for some time now in the m.o.m.® letter is not a financial or economic crisis in the conventional sense, but rather a broad, systemic crisis. One that will continue to unfold even though the economy should expand again for a while.

This Transformation is changing the Old World Order of the 20th century into the New World Order of the 21st century – with major complications where there is an unwillingness to part with old ways of thinking, or softly and smoothly for the most part where there is a willingness to adopt a new worldview, and thus new methods and tools as well. Economic stimulus packages implemented by governments are basically reflective of an Old World mindset, as is inflationary fear-mongering on the part of economists. Events cannot be understood from this perspective.

In this and the upcoming m.o.m.® issues I will be discussing the unseen drivers behind the Great Transformation. Nearly everything will change in the wake of this transformation, including human action, its modes, and its motivations. People themselves will also be changing in terms of psychology. For this shift is accompanied by a radical shift in **mood and mindset**, which are already different today than two or three years ago, even though the Transformation is not even close to being over.

The psychological considerations addressed in the last two issues by Prof. Linda Pelzmann are key to understanding these – especially mood. The chances of keeping abreast of such change are low without such understanding. I am thus pleased to present to our readers time and again the penetratingly insightful views of the unquestionably leading psychologist in this field, and would like to thank Dr. Pelzmann most warmly for her regular contributions to m.o.m.® From the many letters received it is evident how many of our readers have gained a fundamentally new perspective on leadership roles and tasks.

2. Constants in the Tides of Change

Does change simply 'happen', or is it 'made'? Both are true. Change is neither entirely arbitrary and random nor entirely planned and designed, but rather the result of these aspects together in constantly shifting degrees and proportions. Societal systems belong to the still poorly understood category of «**spontaneous systems**» that are self-perpetuating and evolving in nature, which I have written about in the Corporate Policy publication.

We know that it is impossible to fully comprehend systems of such complexity – they remain black boxes. It is striking, however, how the hyper-complex interactions of an astronomical number of factors and influences leading to change evidence systemic patterns and a dynamic structure that can be observed using certain dynamic systems analysis tools. It is almost like discovering a new continent – the knowledge continent of complex systems. That is what this section is devoted to discussing.

The topics addressed in this m.o.m.® pertaining to the Great Transformation 21 are among the most important and interesting of our time. The focus is on the highly complex fields on the **Strategy Map** representing mega-changes, those that are already underway and those yet to unfold, on the forces triggering them and the most likely way in which they will play out.

What is concerned are the systemic relationships between the **solution-independent customer problem** as the Archimedean point of any strategy and the **innovation and substitution processes** in fields 2, 4, 5, 6 and 7 of the diagram below.

Those with the knowledge that enables them to look beyond surface events and identify the constants in the steady flux of change have **tremendous advantages** in terms of competition and survival. This knowledge is in fact **absolutely essential** for finding the solutions, as both a life-saving buoy and a tool for establishing a position in the New World Order.

Entrepreneurs and executives can employ it for orientation, and even utilize the complexity of change to their own benefit in ways incomprehensible to many. Comprehending this complexity and the forces behind it is thus at once the **starting ramp, engine and accelerator** for the new solutions.

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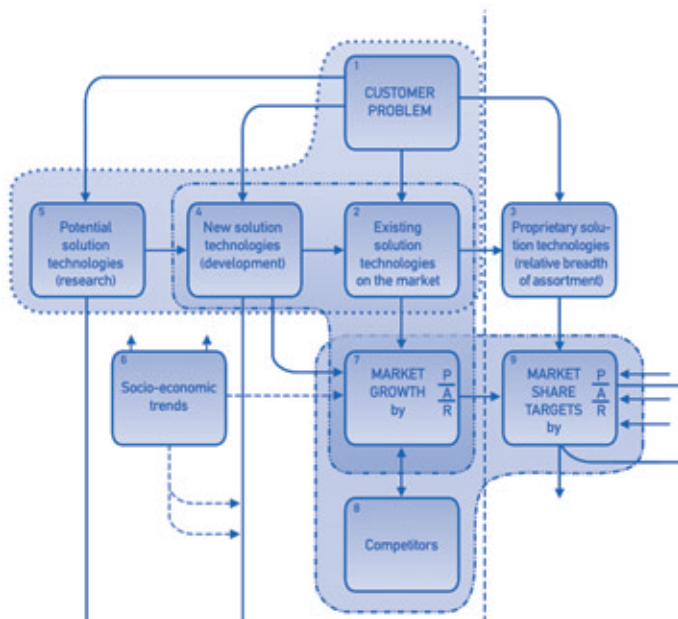


Diagram 1: **Strategy Map** for identifying the driving forces behind the Great Transformation

I often discussed the highly complex issues surrounding finding the right strategies for truly radical change with *Peter Drucker*. It was one of our main topics, and Drucker was one of the very few individuals with whom I was able to discuss the interplay between technology and knowledge, invention and innovation and their successful marketing; this was because of the extensive historical knowledge required that one so rarely encounters, without which the conversion of ideas into practical technologies remains a mystery.

3. The Magic of the Patterns which connect...

«*The pattern which connects ...*» is one of the main themes of a book by *Gregory Bateson* entitled *Mind and Nature, A Necessary Unity*, a pioneer of modern cybernetics and in the fields of communication and evolution theory, who questions: «*Why do schools teach almost nothing of the pattern which connects?*»

Some of these patterns I became aware of long ago, having essentially stumbled across Italian physicist *Cesare Marchetti's* pioneering system analysis research on the S-curve pattern of technological and societal change. It was in the late 1970s, and I immediately recognized the



tremendous relevance of his research work to overarching strategic issues, but also his bionic-logistical method for analyzing such complex systems.

I easily picked up on the theoretical implications due to my long-standing historical interest in the interrelationships between culture and technology in civilizations of antiquity from Rome to China, and on up to the modern age. This extends from the irrigation technologies, monumental architectures and military organizational concepts employed by ancient cultures to the systems approach of today's research laboratories and the radical revolutionary social technology of Syntegration, useful for problem-solving, decision-making and managing mega-change, as previously outlined in several m.o.m.® letters.

Cesare Marchetti was a brilliant thinker in this field, as was Peter Drucker. Both men were first-rate art experts and connoisseurs, which allowed them to see the evolution of art as a reliable contextual leading indicator, as a kind of «handwriting on the wall» with regard to social change – despite its rarely being understood as such. I had often invited Marchetti to lectures and seminars, and talking with him was always electrifying. Today he lives in Tuscany, and is now involved in an ingenious project studying the life and work of *Leonardo da Vinci*.

Marchetti succeeded very elegantly in deriving the patterns and dynamic structures underlying the most complex change processes from the myriad details involved in historical events. Many change processes in the over 3,000 cases he studied extend over centuries, yet exhibit a perfect rhythm much like a symphony led by a conductor – a «hidden control system» governing the great process of **invention, innovation, substitution and exploitation** from initial idea to commercial saturation of the market and renewed substitution in turn by a successor solution concept.

I grasped intuitively that the Archimedean crystallization point of such change and restructuring processes has to be the **inherent, solution-independent user problem**, which I used back then as an anchor in strategy projects in collaboration with *Aloys Gälweiler*. Similarly, I also realized that knowledge of the tides of change opens up the possibility of skillfully surfing upon them; seeing the pattern connecting all systems and subsystems to predict the rising of substantial waves and masterfully harness their power. Suddenly one can find meaning and connections in previously random or disparate-seeming phenomena, allowing the possibility of reliable navigation.

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Suddenly I perceived a new dimension to the concept of a «**solution-independent, user-inherent problem**», as the Archimedean point was not just a user problem pertaining to a particular individual or target group, but rather one extending to the entire **social universe**. It thus became clear all at once how the focus could be shifted onto inherent societal challenges such as survival, evolutionary adaptation, viability and functional integrity.

4. We Too Will Be Replaced...

One of the great challenges for any organization is transforming one type of solution for specific problems into a different type of solution. This lies at the heart of far-reaching transformations. A view of history reveals that no single solution to any problem has ever lasted forever. Every solution is **transient**, i.e. of **limited duration**, and thus is only important for a certain period of time. Similarly, there is never one single product able to permanently dominate a market, as there is always a substitute.

Strategic thinking therefore must be based on an awareness of this axiom:

«Whatever exists today will change – even if we are unable right now to say in what way.»

This is part of what is meant by «self-restructuring» systems. The above axiom gives rise to a second strategic axiom:

«We too will be substituted, though we don't yet know how or when.»

These axioms are of increasing relevance the further a product is distanced from the **inherent user problem**, as every derived solution shares the fate of every preceding solution of ultimately being replaced. The diagram of technological change below illustrates this.

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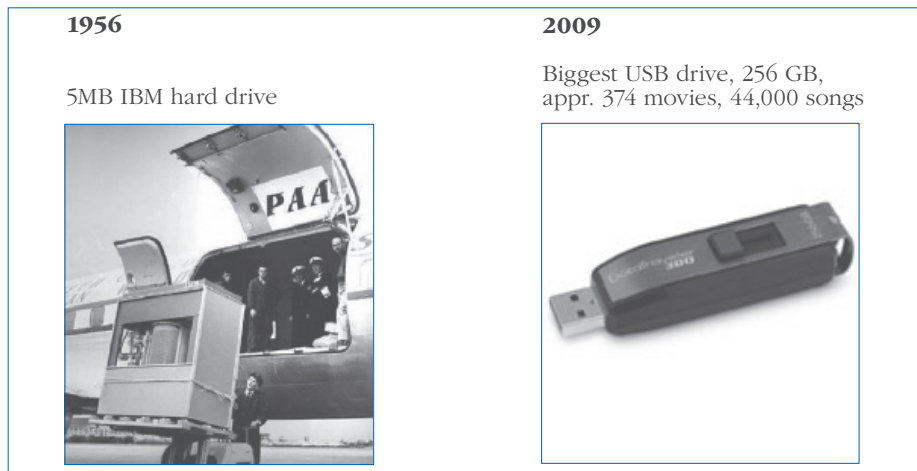


Diagram 2: Technological change

5. Creative Destruction

The axioms noted above conform with one of the leading concepts of change; the idea of «**creative destruction**» advanced by Austrian economist *Joseph Schumpeter*. Schumpeter was the first and one of only a few economists ever thus far to have recognized the crucial role of **renewal and replacement processes** in business activity, as outlined as far back as 1912 in his work *Theory of Economic Development*. This insight forms the core of his economic theory. This idea was advanced most eloquently perhaps by *Nietzsche*, speaking through his character Zarathustra: «*To be a creator, in good or in evil, one must be a destroyer and smash values.*»

In other economic theories, the ideas of the enterprise as a **productive subsystem** of society and the entrepreneur as its **genetic encoding** are practically nonexistent. These theories are brimming with talk of prices and cost, goods and money, and profit or utility-maximizing, ultra-rational economic subjects – but little talk of individuals who innovate and invest at a risk, use loans for financing and actually create and drive economic activity, as *Gunnar Heinsohn* and *Otto Steiger* would later inimitably flesh out in their work **Property Economics** and the book's preceding papers¹, featured in earlier m.o.m.[®] letters.

The **dynamics of change** and its **patterns of unfolding** thus come into view: complex, non-linear interactive relationships that almost always

¹ Heinsohn addressed the topic in the paper «Property, Patriarchy, and the Monetary Economy», 1984.



follow the basic pattern of an **S-shaped curve**, the **equation parameters** of which often can be determined early enough so as to provide a solid basis for major, long-term strategic decision-making in a manner not afforded by any other method.

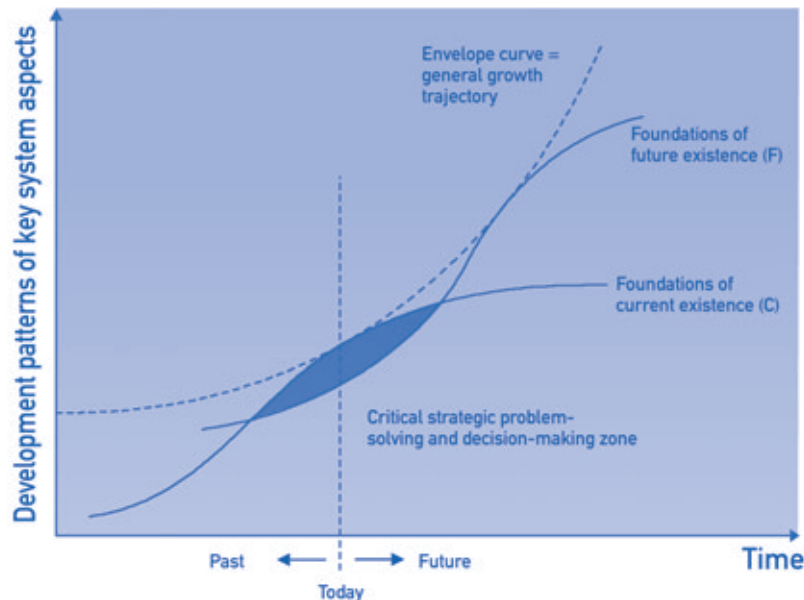


Diagram 3: How transformation unfolds

The diagram above from my *Corporate Policy* publication shows two superimposed S-curves, one of which represents **current success potential** and the other **future success potential**. They both solve the **same** inherent customer problem, but much differently than illustrated in diagram 1.

It follows from Marchetti's research that the economy, and society as a whole, are literally «learning systems»; but they are also «**forgetting systems**» because older elements are constantly being replaced by newer ones, are continually adapting and evolving, and as a result are always generating and incorporating new behaviors, knowledge, tools and methods, even as older ones are being destroyed forever.

S-shaped curves are typical of both growth and learning processes, as indicated by a wealth of biological and behavioral science research. These transformation processes are the manner in which **ideas** – embodied in **inventions, innovation** and ultimately in **products and services** – guide **human behavior** through the mechanism of the markets, and later disappear again from society.



These processes include the **master controls** outlined in my Corporate Policy book, by means of which societal systems structure and manage themselves over long periods of time, thus being stable enough to provide a point of orientation.

The most far-reaching, cataclysmic changes in fact seldom come truly as a surprise. They are only a surprise to those unable to interpret the signs; who are not sufficiently familiar with the tides governing shifts underway. Change is only a surprise for those arrogant enough to deny it; those who claim to be master of the events instead of accepting that they themselves and the decisions they make are part of larger, overarching systems governed by rules of their own. These S-curves are among the fundamental insights that allowed me to predict early on the Great Transformation 21 from the Old to the New World Order.

6. The Symphony of S-Curves: Seeing the Future Clearly

In his research, Cesare Marchetti analyzed highly complex systems, arriving in nearly every case at the same striking patterns and interrelationships.

For this m.o.m.® letter I have selected a small number of examples from his repertoire from a range of areas, to which I have added some of my own to illustrate the basic pattern and its universal applicability, giving the reader a feeling for the laws governing dynamic change processes in complex, self-restructuring systems. I will not be addressing methodological questions pertaining to bionic system analysis here. Additional and more complex applications will be addressed in subsequent m.o.m.® issues.

Marchetti's work spans an extremely broad spectrum of different areas including the automotive industry, transportation and freight infrastructure, energy supplies systems, the dynamics of urban development, the intellectual production of artists and scientists, demographic and ecological systems, climate issues and the dynamics of inventive and creative bursts.

The S-curve, also known as the **logistic curve** or function, is the basic pattern characterizing healthy, natural growth. Growth proceeds slowly at first, then accelerates exponentially, reaches an equilibrium point, flattens

out and then levels off at the level of system saturation. Healthy growth is S-shaped. Any other type of growth, including particularly the concept of linear growth dominating economic thinking, is improperly controlled, unhealthy growth, similar to cancer.

Without performing any calculations, simple knowledge of the existence of S-curves allows us almost like magic to gain an entirely different perspective on the future than is possible with conventional forecasting methods. Instead of forecasting individual metrics, **pattern forecasts** are generated that in turn allow closer determination of individual pattern factors. This is done by abandoning conventional linear extrapolation in favor of the **exploration of patterns** in the behavior of complex systems.²

7. Simple Growth Processes

The first example derives from the natural world: the growth of sunflowers. It takes about 85 days for the plant to reach a height of 2.5 meters. Growth times and growth parameters vary widely of course for other biological forms, yet the **pattern for healthy growth** is always the same. A colony of bacteria in a lab dish for example takes 4 - 5 days to grow in S-fashion to occupy the entire surface of the dish, the measurement unit in this case being square centimeters.

Thus it is possible to «**predict**» growth processes in a strictly scientific sense. In many cases even a small amount of data is enough to approximately predict three things, the importance of which for business strategy can scarcely be overstated: 1) the **absolute qualitative level** at which growth stalls; 2) where the **equilibrium point** along the S curve will be (key for determining the rate of growth) and 3) **how long** the process will take. Thus based on a growth pattern it is possible to estimate market and sales volume and growth rates, as well as how long it will take to reach these levels.

These orientation markers are of inestimable value for strategic decision-making. The **statistical precision** with which such estimates can be

² Known to most only as an ultra-liberal economist, Friedrich von Hayek's more important work concerned a theory of complex phenomenon and spontaneous order which I drew upon in 1976 for my doctoral dissertation entitled «Strategies of Complex Systems», and which essentially forms the theoretical foundation of my management theory. Hayek looks at pattern explanation and pattern prediction in the article «Degrees of Explanation» in Studies in Philosophy, Politics and Economics, Chicago 1967.

made is often astounding. In practical application, however, this is not as important as some believe, who are interested in demonstrating what the S-curve is unable to do. There are always people after all who are mainly interested in pointing out what cannot be done. Like every methodological instrument, this approach too has its limitations, which it is just as important to know about as what the benefits of this type of pattern exploration are.

Statistical precision, within certain boundaries, is less important than the system pattern itself as critical decisions, concerning production capacity at market saturation level, for example, do not have to be addressed immediately, but rather decades down the road. Instead, it is prudent to grow with and into the market, deferring risky decisions to the latest possible point. Progressing down the curve, individual data elements become more precise – or it may happen that the pattern becomes unstable, going off in an entirely new direction. Both provide **points of orientation**, without which one is simply lost in the dark while having to make risky, arbitrary decisions – including doing nothing, the default decision that in most cases is the riskiest course of action.

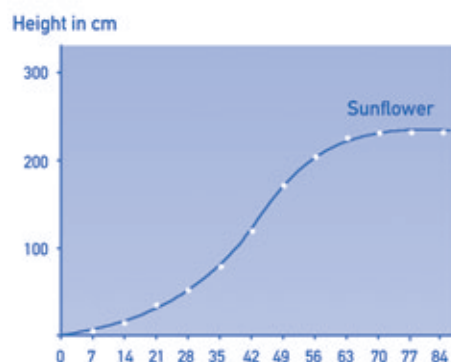


Diagram 4: Healthy sunflower growth

The same pattern is found in **socio-technical systems**, such as the absolute growth in the number of cars in Italy and other countries between 1950 and 1990 (upper left in the next diagram) and the market share of digital cameras between 1990 and 2005. Looking at the data material with the S-curve in mind, one can focus on finding it, and it may not take long.

One may object that these examples have been selected ex post, with the benefit of hindsight. While that is true, these patterns occur so frequently – nearly all the time – that it must be the case that they are actually there

before we look for them. The question here is at what point can one draw which conclusions from the exploration of data material. In complex cases, every bit of information one has is valuable.

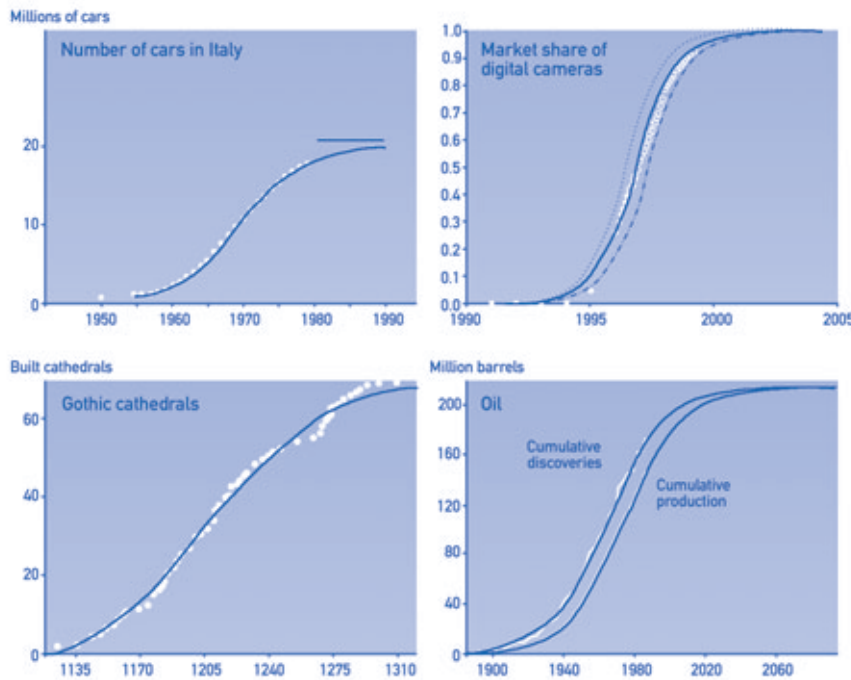


Diagram 5: Further growth curve examples

The diagram below left shows the growth pattern for the building of Gothic cathedrals in Europe over a period of roughly 200 years, measured on the basis of the cumulative number of cornerstone layings for cathedrals considered completed over time. Another example (chart below right), part historical and part projection, is the growth in discovery and mining of oil deposits, which have proceeded in parallel in S-shaped fashion. The curves are measured from around 1900 but the trends go back to 1850, thus spanning a period of roughly 200 years, like the phase of Gothic cathedral-building. The saturation point of cumulative exploration and production will likely be reached sometime between 2020 and 2030, which is of considerable significance in relation to current assumptions.

The last example concerns the productivity of *Mozart*, expressed as the cumulative number of composed works. This curve follows the same logistic function pattern seen with numerous other artists and scientists

Marchetti studied, including *Bach, Boltzmann, Botticelli, Tintoretto and Shakespeare*. By age 35 Mozart had completed 96% of his life's work.

The implications of this pattern definitely give one pause, but are not the subject of the m.o.m.® letter. What we are concerned with here is pointing out the ubiquitousness of the S-curve across a wide range of phenomena and the strategic conclusions that can be drawn.

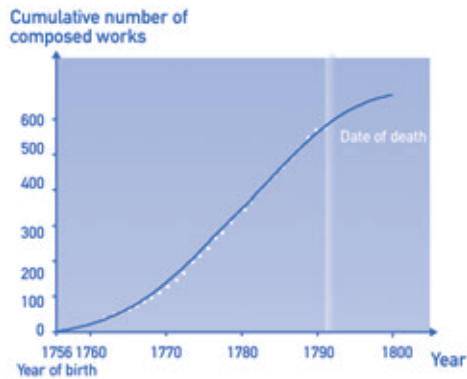


Diagram 6: Mozart's productivity

In the next issue of m.o.m.® I will be discussing more complex examples of dual and multiple substitution processes, as recorded on the Strategy Map in diagram 6. Proceeding along to consider infrastructure and energy sources we will come to the fundamental invention and innovation processes that have driven great transformations in the past and are again in play right now. These processes precede economic developments, as the long-unrecognized tides affecting **Kondratiev waves**, which I will be discussing in view of their relevance to financial market events over the months ahead.

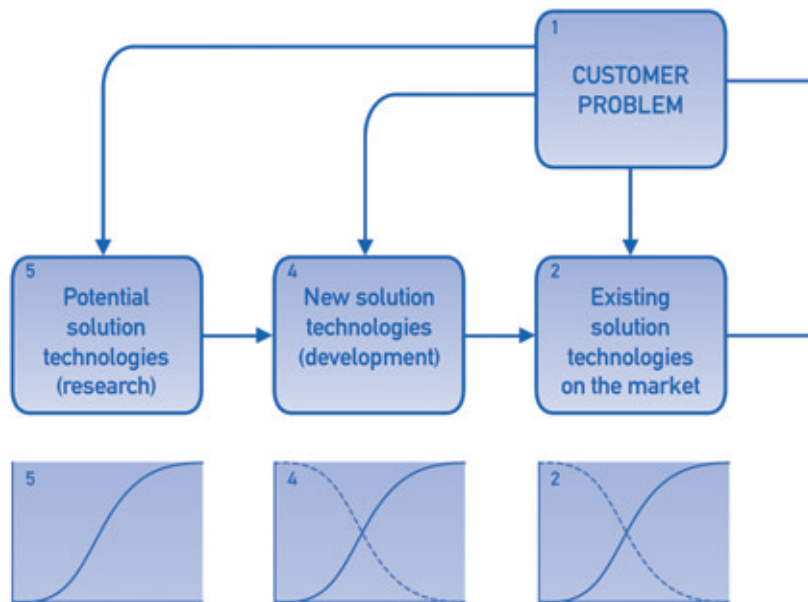


Diagram 7: «Deep sea currents», invention, innovation and substitution

8. Was Kondratiev Right? The Rhythm of Long Economic Cycles

To be able to assess a situation and know the right course to steer, it is essential to know something about Kondratiev or **long-term economic cycles**. Most economists today know little about them, or dismiss them out of hand because they do not fit in well with their mathematical equations. These cycles do; however; conform to the evident rule of nature that there is no perpetual, even growth, which instead cycles in and out like the seasons.

From the mid-1980s on I was lecturing about Marchetti and Kondratiev, and I noticed that roughly one third of the managers and entrepreneurs listening to me would have an ‘aha’ moment, suddenly being able to ‘see’ what they had long felt to be true. Another third of the audience thought it was ridiculous, believing that man is capable of structuring everything according to his own will and designs. The other third considered the idea thoughtfully and with concern. In my June 1993 Management Letter I published a highly detailed analysis of Kondratiev waves and their impact on the real economy and financial markets. This included consideration of elements of psychology and mass-psychology in relation to economic

cycles, about which Dr. Linda Pelzmann has provided such valuable insights.

In the 1920s, Russian economist *Nikolai Kondratiev* advanced a theory based on studies of price movements of a hidden pattern governing short-term economic cycles, which he claimed was a **long-term, wavelike movement** in the economy spanning roughly 57 years from beginning to end. I will not be addressing certain statistical problems pertaining to this theory, as these do not affect the significance of the main idea.

Kondratiev's findings are hugely valuable in attempting to identify landmarks and basic patterns while struggling with complex and risky strategic decisions in the face of day-to-day events and turbulent change. Four historical cycles are the subject of exhaustive research:

1722 – 1784 62 years

1784 – 1842 58 years

1842 – 1896 54 years

1896 – 1949 53 years

These periods correspond astoundingly with the invention and creativity bursts Marchetti has observed, which will be the topic of the next issue. Kondratiev cycles appear to be the economic consequences of underlying forces: ideas, invention, technology, innovation and entrepreneurial marketing.

If history should be repeating itself with respect to the above cycles – which I outline as one of the most probable outcomes in my **System Scenarios** (responses to which may vary employing older or newer methods) – the Kondratiev cycle we are currently in began in 1949, reached its growth equilibrium point at around 1980, has been in a plateau phase since the year 2000 roughly and since then has been in a basic trend of decline that will last until around 2013 – 2015.

The dates vary depending on whether one takes the shortest or longest historical K-cycle as a forecasting basis, but this is largely irrelevant for the purposes of practical corporate management, as the next growth phase does not commence across all industries simultaneously at the end of a 'calendrical' K-cycle. Long furrows characterize Kondratiev cycles, so that it may take many years before an upswing is strong enough for the general public to notice.

In the past this has been due to psychology and mood. New methods, like **Syntegration** in particular, can positively impact mood within as little as 3 ½ days, explaining why users have frequently referred to it as «a miracle method». Applying this revolutionary, innovative approach across a broad front would not immediately change economic realities, but it would radically change the **mood** and **mindset** of the general public.

Thus in this particular regard history does not have to repeat itself.

9. Self-destructing and Self-creating Systems

A trait shared by **all** historical Kondratiev cycles has been the coincidence of dramatic, extended bull markets in securities, which have always petered out in the plateau phase, to be followed by major **bear markets and crashes**. In the first Kondratiev cycle, prices fell 70% from their peak, in the second by 80%, in the third 50% and in the fourth cycle by 90%. Price declines generally occur in the final fifth or even sixth of a Kondratiev cycle, yet are still met with complete surprise, since the economy had been going so well and prosperity steadily increasing. The deep sea currents of the transformation long underway inside the system could not be read from economic data on the surface, or were not interpreted within the right context.

Part of the tragedy of our market economy system, poorly understood in certain aspects, is that **financial market excesses** have been several times greater in proportion than **real-economy fluctuation**. These excesses have turned recessions into depressions, regardless of what governments, central banks, treasuries and other institutions have undertaken in such periods. The financial sector becomes increasingly decoupled from the real, producing economy farther along a K-cycle, taking on a life of its own. Lending volumes exceed real economic demand for loans for capital investment and business purposes by an unbelievable factor of 3 - 4 times.

In time – contrary to popular opinion and economic theory – **financial markets cease being actual markets in a true, economic sense**, because the laws of supply and demand increasingly no longer apply to them. The more a stock goes up, the more people want to buy it, and the more it falls, the more people want to sell it at any price. The exact oppo-

site is true in real markets: as goods become more expensive, like tomatoes or cars for example, fewer are sold, and vice versa. Movements that are self-regulating in the real economy escalate self-destructively in the financial economy.

One characteristic mechanism involved is the buildup of **excessive debt** fulfilling no productive purpose, creating a bubble in the financial system. When loans can no longer generate interest and principal payments, in the end they have to be written off and eliminated in a **deflation process** generally involving mass bankruptcies of businesses and governments, and in many cases a decade or more of economic torpor.

It is not known why Kondratiev cycles and the Marchetti waves of invention and innovation observed in earlier periods last approximately 55 years. But it has to do in any case with the way in which human beings learn, teach and forget over generations.

These time constants also appear to stem from **mass psychology³ phenomena and societal moods**, which form the focus of a new research discipline known as **socionomics⁴**. This discipline has already yielded fascinating findings which, if correct, offer the prospect of revolutionary insights of far-reaching consequence. At the heart of socionomics is the hypothesis that the idea of causality in social systems, derived principally from classical physics, has to be reversed. It is accordingly not **external events** that provide the causes or reasons for human action, but rather factors internal to man himself, i.e. **endogenous, mass-psychological mood phenomena** that determine behavior irrespective of external events. Endogenous mood swings from collective optimism to pessimism and vice versa, according to the findings obtained, determine collective perception and interpretation of events. Actions taken will thus vary depending on whether people perceive a given event in a positive or negative light. A typical cybernetic feedback loop is therefore in evidence, only reversed with respect to classical physics.

³ Linda Pelzmann, m.o.m.® 11/2002, The Triumph of Mass Manufactured Will, m.o.m.® 02/2003, Collective Panic; Malik, Constantin, 2010, Ahead of Change - How Crowd Psychology and Cybernetics transform the Way We Govern. Campus, Frankfurt. Dissertation, April 2006

⁴ Prechter, Robert R. Jr., 1999, The Wave Principle of Human Social Behaviour and the New Science of Socionomics; Gainesville John F. Casti, 2010, Mood Matters, From Rising Skirt Lengths to the Collapse of World Powers, New York

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