Business Friendships

Properly managed and nurtured, friendships with colleagues and competitors can be good business.

The inescapable fact of the modern workplace: the more connected professionals are through off-hours events, e-mail and business travel, the more they must learn to manage the spillover between their work lives and their personal lives. But can friendships that start on the job become meaningful offsite friendships? And what does that mean for business?

“Sometimes people try very hard to draw a firm line between the people for whom they have genuine affection and those with whom they’re involved professionally,” Professor Paul Ingram says. “The economic aspect of the friendship undermines security in the social relationship,” he explains. “People wonder, would they be going to the ball game with me if we weren’t doing business? Do they care about me or is it reflecting some economic interest?” Others might worry — as might their employers — about a close friendship with a competitor engendering collusion or a conflict of interest.

But Ingram cautions against rejecting business friendships — relationships that have both economic and social implications — out of hand. Not only are such friendships likely to be rewarding for their own sake, they are likely to be good for business in all kinds of ways.

Ingram and PhD candidate Xi Zou examined the dynamics of business friendships to learn about how professionals successfully...
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balance the dynamics of trust, loyalty, emotional connection and professionalism within the bounds of such relationships. The team looked at a large body of research (including some of their own studies) to assess the benefits and consequences of business friendships.

Perhaps not surprisingly, views on business friendships vary by culture. In China, professionals rely on their friendships to run firms, acknowledging that personal ties can help build trust and accountability into professional relationships. For example, finding that a colleague comes from the same village is viewed as evidence of reliability and trustworthiness.

In the Australian study, the researchers found that certain friendships between managers at competing hotels were worth approximately $268,000 in 1998 U.S. dollars to each hotel. Ingram estimated that the industry-wide revenue attributable to business friendships would have been 15 percent, or $90 million. Importantly, Ingram and Zou found no evidence of price fixing or that there were any violations of antitrust law.

One manager told Ingram of a negotiation between himself, a tour operator and a manager from a different hotel that illustrates how the absence of business friendships can impact revenue. The operator conducted the negotiation for a large block of rooms with each hotel manager simultaneously, with a telephone in each hand. He would take an offer from one manager, ask the other to beat it and then repeat the process. The tour operator was effectively running an auction, playing the two managers off each other. “They realized what was happening of course,” says Ingram, “but had they been friends, one of them would have thought, we’re going to get driven down to our marginal cost, so I’ll stop participating in this negotiation and I’ll let my friend get the business with some profit and trust that he’ll return the favor to me in the future.”

The researchers also found that business friendships go through various phases as a person’s career advances. Early on, people usually have a larger social network with more connections to people both inside and outside their firm. Even when such relationships are not particularly strong, exposure to a variety of people can be invaluable in generating ideas and gaining perspective. “People engaged in these networks are often viewed as more creative and resourceful by their colleagues,” Ingram says. “Sometimes a big idea or an innovation that can change the trajectory of a company comes from combining evidence and ideas picked up from social relationships.” As one advances to more senior and executive roles, trust becomes a top priority and the size of the network decreases, but its cohesion and closeness increase.

Although business friendships can be stressful and difficult to manage, when acknowledged as a normal aspect of professional life, they can bring substantial career benefits. “Most people find jobs through colleagues and other professional connections,” Ingram says. Further, colleagues in the same organization who develop friendships with their structural peers—those who hold roughly equivalent positions in the hierarchy and who are often assumed to be competitors for promotion—were overwhelmingly more likely to identify each other mainly as sources of support rather than as potential rivals.

Ingram cautions that the benefits of business friendships can be reaped only when the friendship is genuine. “Without some element of trust and some element of liking you can’t be confident that someone would return a favor,” he says. “I just being in someone’s Rolodex isn’t enough.”

Nor should business friendships be taken for granted. “We live in a world where a social exchange can solve problems that can’t be solved in the arms-length world of formal contractual agreements,” Ingram says. “We have to systematically recognize and nurture these relationships.”

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Paul Ingram is the Kravis Professor of Business in the Management Division at Columbia Business School.
The Advantage of Not Knowing It All

Q&A with Rita Gunther McGrath

In a new book, Rita Gunther McGrath discusses how taking calculated risks, while learning along the way, can pave the road to success.

Q. What is discovery-driven growth, and how does it differ from conventional growth?
A. Discovery-driven growth is an approach to developing new businesses that deliberately contains risk while allowing firms to grab opportunities. It’s a very step-by-step approach to growing into new areas of development, whether that’s increasing revenue by expanding an existing venture or starting from scratch. Unlike the conventional planning process, in which managers are expected to have a lot of knowledge, discovery-driven growth recognizes that in a new venture it’s better for managers to learn along the way.

My coauthor Ian MacMillan and I started writing the book with the intention of speaking to people who were in new-business-development or growth roles. We found, however, that given the recent economic upheaval, people find discovery-driven growth useful, even in their formerly stable core businesses. This approach allows managers to test assumptions at each step, before making a big commitment to a particular kind of investment—like creating a pilot plant before opening a full-scale production plant.

Q. How can a firm transform its core business to be more competitive?
A. We’re increasingly coming to understand that we don’t live in a world of sustainable competitive advantages—firms’ value-creating processes can be rapidly duplicated or imitated by others. It takes innovation to transform your company’s capabilities to facilitate ongoing success in such dynamic environments. Innovation is about continual renewal, realizing that competitive advantages are temporary. It’s about getting into new markets, developing new offers and creating new business models. Managers need to think about future advantages and opportunities as soon as they have an established business—taking a step away from the core business of today and looking ahead to anticipate the big opportunities of tomorrow.

DuPont is a good example of an organization that reinvented a lot of its basic business models in this way. Some years ago, it went from a company that primarily manufactured materials to a company that got paid for its knowledge about processes and for the solutions it could provide. It has successfully left a good but slow-growth business—textiles—and moved into producing faster-growth products such as light-emitting diodes and bio materials—green technologies—placing its corporate growth rate on a much more positive trajectory.

Q. Right now many companies are working very hard to keep their heads above water. How is it possible to successfully grow in a tumultuous economic landscape?
A. The time to build for the next upturn is during a downturn. A lot of new firms that are founded during recessions actually do very well. Google, for example, went public in 2004, on the heels of the 2001 recession. Downturns provide opportunities for companies to consider growth in areas that previously would have been inaccessible—either because it was too expensive or because of fierce competition. Recessions also force companies to be very careful with how they spend money and to be very thoughtful about which customers they want to serve, which are very good things to do.

Q. How should managers approach discovery-driven growth, and what should they expect in terms of how much and how fast to grow?
A. The first step is setting a framework within which people can operate that gives managers a sense of how big they want the new venture to be or how fast they want it to grow—some goals. Then, they need to look at their operation and decide what mix of investments are likely to get them there. Some investments will be things that rejuvenate the core business, like education initiatives for employees or improving operational effectiveness and cutting costs. A pple, for example, turned around its slumping business in large part by slashing expenses from $8.1 billion in 1997 to $5.7 billion in 1999. Others move the business into uncertain territory; with these investments, a manager should be looking more toward the future. Beta testing software before fully launching it, for example, allows managers to make a small investment today and have the option, but not the obligation, to invest in a launch later on.

Then, he or she should drop down to the individual-initiative level and spell out what each initiative will accomplish. As the venture unfolds, the goals should be continually revisited to see if they remain realistic and practical.

Finally, it’s essential to recognize whether it’s time to disengage. A manager, for example, might learn at the end of a product market-test that consumer demand doesn’t exist where he or she thought it did. This is an example of learning along the way.
It's also important to be aware of not growing too fast or too slowly. Starbucks, for example, grew so fast that the market wasn't there to sustain it—it's had to significantly scale back. Alternatively, if a company grows too slowly, it is vulnerable to being taken over, it can have its business erode and it risks not rewarding its shareholders.

**Q.** How can a firm assess whether a new venture is on the right track and what it should do differently?

**A.** Traditionally, people spend weeks or months putting together elaborate PowerPoint presentations and spreadsheets, and then they go to their board or funding authority, which says, “Great. We approve.” They leave with an incredibly detailed plan that they're supposed to execute. One month, two months, six months may pass before they realize that things aren't going the way they had expected. In a typical corporate environment, the pressure to keep going can be overwhelming. No one wants to admit to being wrong.

We recommend allocating smaller amounts of money and evaluating the venture at each step of the way. So, a manager might receive $10,000 to do a market test. If that test proves successful, his or her firm's funding authority would allocate additional money for the next step, and so on. If at any one of these steps things aren't working out, we recommend that he or she do a thorough disengagement analysis.

**Q.** And what if the best course of action appears to be disengagement? Is it possible to disengage—or to fail—productively?

**A.** I think redefining failure is the first step. It's important to communicate with your team and to impose the concept of intelligent failure, rather than stupid failure. An intelligent failure is one that's been well planned; where there's some hypothesis that you're trying to test; where you'll learn something no matter what happens; and where the risks have been contained.

Historically, most successful new-product and service launches are a result of things that didn't work out. A great example of this is how Amazon.com got into third-party selling. It started off with a thing called Z-shops, giving a third-party vendor its own section of the Web site. That wasn't successful, but it gave Amazon the idea to put third-party vendors below its own listings. That didn't generate significant revenue either. So, Amazon started a system where it put third-party listings right up against its own, which was a little trying because outside vendors were being given the same shelf space as Amazon's internal people. All of these improvements allowed Amazon to expand its footprint in this third-party channel, which now accounts for one-third of its revenue. The earlier trials that didn't work out paved the way for the later opportunity that did.

**Q.** It is daunting to learn that only one of every 3,000 raw ideas succeeds. How does that one idea make the cut?

**A.** I suggest keeping an idea inventory to track ideas that look promising, revisiting the list periodically to see whether an idea's time has come and being prepared to drop the ideas that become less promising over time. It's also important for an organization to be receptive to fostering ideas—it has to pursue as many small and inexpensive ideas as possible. The two processes work together; eliminate those ideas that don't have a future and, at the same time, nurture those that have potential.

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Rita Gunther McGrath is associate professor of management at Columbia Business School.

www.gsb.columbia.edu/ideas
Engaging Consumers, Creating Value

Findings on value creation and regulatory fit offer far-ranging implications for management, marketing and even mental health.

Value—how much importance or worth people place on any given thing—is a big idea packed into a small word. But to get at where value comes from, says Professor E. Tory Higgins, value must not be thought of exclusively as a positive thing. Higgins, who has spent much of his career considering questions related to motivation, investigates the origin of value not by focusing on where it comes from, but instead by asking, “What is it that makes something valuable—whether positively, so that you are attracted to it, or negatively, so that you are repelled by it?” Motivation is part of the answer. For centuries, motivation has been attributed to pleasure and pain; Higgins has shown that pleasure and pain give direction—attraction or repulsion, toward or away from—to motivation. “Simply put,” he says, “pleasure is related to something that we approach, something we want to happen; pain is something we avoid and want not to happen.”

Intensity, too, plays a role in value. “Whether you are choosing a partner or choosing between different dishes at a restaurant, many of our choices are between positive things, all of which would give pleasure. So the question of intensity is critical.”

The accepted view about intensity is that it is driven by pleasure and pain: the more pleasure something gives, the more intensely positive it is, and the more it avoids or takes away pain the more positive it is. But Higgins’ research implies otherwise. “Yes, pleasure and pain contribute to intensity. But it’s not clear that pleasure and pain make the biggest contribution.” Instead, Higgins suggests that a bigger contributor may be engagement. “We are constantly moving from act to act in which we are more or less engaged in what we are doing.” How strongly we are engaged, says Higgins, is a major determinant of how much we value things. Unlike pleasure and pain, engagement doesn’t give direction—it doesn’t attract or repel people to things. Instead, it intensifies, making positive things more positive and negative things more negative.

To explore the role of engagement in intensity, Higgins theorized that people are more likely to become fully absorbed in the present when preparing for events that are likely to happen in the future. He and his co-researchers asked subjects to rate two different yogurts (one flavored with nutmeg to taste good, the other flavored with clove to taste bad) as part of a study the subjects believed would help a dairy company determine which new yogurt flavors to feature.

In one of Higgins’ studies, subjects were eligible for a prize if they completed an anagram. They were primed to perceive aversive background noise—a conversation or a dentist drill—as either interference to overcome or as something to be coped with (a more passive act). Consistent with the researchers’ hypothesis, subjects who took the more active step of opposing the distracting background noise became more engaged in completing the anagram. This group also attached a higher value to their prize, while the subjects who merely coped became less engaged with their task and did not value the prize as much.

“That the value of the prize increases even though the experience is negative is not something that is obvious from the conventional view of hedonic pleasure and pain,” says Higgins.
Higgins’ insights into engagement and value may upend one axiom of economics. “The principle of scarcity assumes that the value of any scarce thing goes up and, accordingly, becomes more positive or attractive. But in most cases when that happens, it is something positive that is scarce.”

Higgins thought that scarcity might function more like a barrier—as something that can increase or decrease eager way, constantly looking for ways to advance; they are risk-tolerant and likely to consider a number of courses of action when confronted with a task or problem. In contrast, prevention-driven people tend to pursue their goals in a cautious way, acting vigilantly to avoid errors and minimize risk.

When a person in a promotion state finds himself working in an organizational culture that prizes risk taking and innovation, he is said to experience regulatory fit. If that same person then goes to work for a company whose ethos emphasizes vigilance over risk, he will probably have a hard time—the work culture is a nonfit for his regulatory state. Likewise, when a prevention person finds herself in an eager, risk-taking work culture, she’s in a nonfit. And, Higgins has found, when people experience nonfit environments—whether they are promotion- or prevention-driven—they disengage.

Combining the principles behind intensification and engagement can work across a broad range of situations. Managers and influencers can consider ways in which engagement needs to be strengthened or weakened, which can often serve the dual purpose of creating a more positive experience (in the case of strengthening engagement) for staff while at the same time reducing operational costs associated with reduced resistance.

Marketers may be able to use nonfit as a tool to prompt consumers to think about reasons they have not, for instance, purchased green products in the past. For example, a promotion person does not tend to make decisions in a careful, thorough way, and being asked to do so creates a nonfit. The disengagement brought on by the nonfit condition can deintensify some beliefs and perceptions. “If you ask a promotion person to write down the evidence for why he doesn’t like or isn’t willing to buy green products, that sort of vigilant approach is a nonfit. In a nonfit his positive attitude toward his evidence is deintensified. He may in fact be running through evidence for his position, but that act can undermine his bias against purchasing green products,” Higgins explains.

Because experiencing regulatory fit tends to make people “feel right” about what they are doing, Higgins suggests that people try to carry out difficult tasks in a fit way. For example, parents contemplating buying life insurance may see it as important but feel anxious about doing so given that it implies their impending deaths, however far removed that may be from the moment. In such an instance, strengthening engagement to intensify their positive view on buying life insurance in a way that makes them feel less anxious about the decision could be useful.

Finally, there is some evidence that people feel better when they manage their emotional problems in a way that is consistent with their regulatory fit; Higgins is now exploring possible mental health applications of regulatory fit.

Higgins is not surprised to find value woven so deeply into so many assorted disciplines. “Value is central to theories of psychology, consumer behavior, political science, management, organizations and marketing,” says Higgins. “And motivation is all about value and value as incentives. It is present in every aspect of life, in everything we do.”

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E. Tory Higgins is professor of management at Columbia Business School.
What’s Fair, and Who’s to Blame
How judgments about our own behavior impact our perceptions of fairness and blame in others.

Split your pie in half to share, and you may be seen as a Pollyanna. But offer two-thirds of a pie when you have two pies in hand, and you may be viewed as a miser and treated accordingly. “In theory,” says Professor Boğaçhan Çelen, who studies strategic behavior, “the receiver should happily accept any pie, since some is better than none.” But that’s often not the case. The idea behind the theory is that people are fundamentally rational creatures—homo economicus. But ultimatum game experiments consistently show that people are not as rational—or as selfish—as has been assumed, and, in fact, behave quite altruistically.

What would I do IF I WERE IN HIS OR HER POSITION?

In the ultimatum game, two opponents must divide a dollar. One person, the proposer, makes an offer to divide her dollar. If the other player, the receiver, accepts the offer, the proposal is implemented. However, the receiver always has the option of rejecting the offer, in which case neither player receives anything.

“But when you run the experiment,” Çelen says, “not only do proposers consistently offer much more than one cent, but if they offer too little—for example, 10 cents—then their offers are consistently rejected.”

Why are proposers so generous, and why do receivers set their sights so seemingly high? Çelen and his coresearchers, M ariana Blanco of Universidad del Rosario and Andrew Schotter of New York University, explain the consistency of these behaviors with a concept they call blame-freeness.

Consider a round of the ultimatum game in which a proposer offers 10 cents. “We theorized that the receiver actually considers what she would do in the position of the proposer,” Çelen says. “If the receiver herself would have offered only five cents, she accepts the proposal because it meets her standard for blame-freeness—she views the offer as fair. If the offer is less than she herself would have offered, she is more likely to reject it, depending on just how strongly her sense of fairness is offended by so low an offer.”

To test their notion of blame-freeness, the researchers created an experiment in which two players face off against each other in a tournament. Players begin with equal amounts of cash, and each uses some of her cash to purchase whatever amount of effort (in the abstract) she wants to exert in the tournament.

The cost of effort was central to the tournament, since greater effort increased (though did not guarantee) the likelihood of winning.

But some players were granted an advantage by the ability to buy effort cheaply, leaving other players—those for whom effort cost much more—disadvantaged. A player for whom effort was cheap could choose to purchase lots of effort and still have plenty of cash left over. This allowed the researchers to see whether the players took others’ circumstances into account in their assessment of fairness. For example, one player might be willing to exert lower effort against a disadvantaged opponent when the cost of her effort was low, but higher effort when the cost of her effort was high.

Each player faced off against two others simultaneously, so players could occupy both advantaged and disadvantaged roles in the same session of the tournament. Each player also had an opportunity to punish his opponent by reducing his opponents’ payoff (but doing so also reduced the punisher’s payoff). This allowed the researchers to observe if players were consistent in punishing their opponents, confirming that players were using their own behavior as a reference for judging the fairness of other players.

Players’ choices about whether or not to punish their opponents differed in rounds of the game in which they were able to observe other players. For example, most of the time a disadvantaged player would forgo punishing an advantaged opponent when given the chance—if she had observed her opponent choose lower effort levels playing in an advantaged position.

“This analysis allows us to capture the context: I’m asking myself, what would I do if I were in his or her position? The evaluation is always subjective: an advantaged player’s idea of fairness is different from that of a disadvantaged player. But we end up with a norm,” Çelen explains.

Overall, at least half the time, most people punish acts they deem blameworthy. Alternatively, some people forgo meting out punishment because while they may view an opponent as blameworthy, they don’t view the offense as one that would justify the cost of punishment. “Our work suggests that rather than think so much about being nice or mean,” Çelen says, “people actually assess what is fair based on their own behavior.”

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Boğaçhan Çelen is associate professor of finance and economics at Columbia Business School.
Should You Go with Your Gut?

Decisions based on emotions are more consistent—and might be more satisfying—than those based on deliberation.

Faced with the same set of choices on different occasions, most consumers choose the same thing again and again. Marketers rely on consumers’ preference consistency to conduct some of their most important activities, such as customer relationship management and new product development. And research has shown that people like to believe that they make consistent decisions.

If it is clear that consumers are consistent in their preferences, it is less clear what drives consistency and the decision-making process. The idea that decision making is driven primarily by conscious, cognitive mental processing—the rational man theory—has fast been ceding ground to the idea that people might make choices in ways that are less obviously rational. There’s even a growing body of social science research showing that, in many instances, thinking too much can deteriorate the quality of decisions.

Professor Leonard Lee worked with On Amir of the University of California, San Diego and Dan Ariely of Duke University to investigate what drives the consistency of consumer preference. In particular, the researchers theorized that consistency might be the result of an emotionally driven decision-making process.

Lee and his coresearchers adopted a concept from economics—transitivity—to measure preference consistency. A person who chooses a hot dog over a chili dog and a chili dog over a turkey burger should, according to the preference consistency paradigm, choose a hot dog over a turkey burger. “But if I chose a turkey burger over a hot dog, that means my choices are not that consistent. I have violated transitivity,” Lee explains.

To measure transitivity violations, Lee and his coresearchers showed subjects 10 different products in different pairings, repeating the choice sets several times. To evoke varying degrees of emotional processing and cognitive processing in subjects, the researchers presented the choices in different formats. For example, images elicit more emotional responses than words, so in one round subjects were shown choice sets in words while in another round they saw choice sets in images. Color photographs prompt a more emotional response than black and white photographs, so in some rounds choice sets were presented as color photos, while in other rounds choice sets were presented in black and white.

The researchers tracked how many times subjects violated transitivity in each choice set. When subjects chose from products presented in formats designed to provoke a more deliberative decision-making processes, they accumulated more transitivity violations: their choices were less consistent than when they chose from products presented in more emotionally evocative formats.

“You might think that carefully weighing pros and cons about a decision would lead to greater preference consistency. But we actually found the opposite,” Lee says. “Decisions we make based on our emotions and our gut are actually more consistent.”

For marketers, this means it might make more sense to use affective cues to elicit emotional processing in consumers, instead of merely listing all the features of a product, which could induce greater cognitive processing.

For consumers, the research implies that satisfaction might be linked to preference consistency—those things people choose consistently time and again are probably the things they will be most happy with. If that’s the case, consumers might want to put greater trust in how they feel to help guide their purchasing decisions and invest less time weighing pros and cons.

That emotions actually play a significant role in decision making, Lee cautions, should not be conflated with the idea that relying on emotions means that humans are somehow irrational. “Evolutionary psychology suggests that our emotional systems have evolved over millions of years to help us deal with important decisions in our lives effectively and efficiently,” he says. “That implies that our emotional system is functional and has a lot of value.”

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Leonard Lee is assistant professor of marketing at Columbia Business School.
What About All the Irrational Stuff?
Q&A with Morris Holbrook

Almost thirty years ago, Morris Holbrook and his colleagues stirred up a sea change in consumer research, tabling the old rationalist model and exploring the emotional side of consumer behavior.

Q. How did you land at the School?
A. I started at the School in 1965 as an MBA student and stayed on to complete my PhD. John Howard and Jagdish Sheth, both members of the faculty then, wrote a monumental book in the field called The Theory of Buyer Behavior, which was among the first works that systemized our understanding of consumer choices, identifying the decision-making process and observing its changes over time.

I was lucky enough to be an MBA student in John’s class when he was working on the book. He would come in and pass out mimeographed copies of his latest chapter. Our homework assignment was to read and critique it. And I was really fascinated by this stuff. So I got to be friendly with him, and he became a kind of mentor and eventually became my sponsor in the PhD program.

Q. What are the most significant shifts in marketing research you’ve seen over the course of your career?
A. The advent of buyer-behavior theory itself was a huge watershed, part of the recognition that you had to look at the customer. Before that you might study retailing or salesmanship. The buyer-behavior work was a significant development. But then again, I started my study at the same time so it has always existed for me.

But even as buyer-behavior theory did represent the elevation of the customer, at the time everything was much more quantitative. Researchers believed, for example, that consumers absorbed and processed brands and advertising campaigns at face value, as if the consumer’s personal experiences and opinions didn’t inform and alter his or her responses and reactions.

The role of emotions in the decision-making process had been explored in the 1940s and 1950s but was subsequently abandoned. Then in the 1980s a bunch of us wondered, wait a minute, what about all the irrational stuff, the daydreams, the emotions, fantasies, biases and misperceptions? My colleague Beth Hirschman (now at Rutgers) and I lumped it together under the heading of the consumption experience in general and fantasies, feelings and fun in particular.

We didn’t realize it at the time—though we now realize it very forcefully—that the consumption experience was not a new idea. We thought we’d invented this great new idea! But it goes way back. We traced it to Adam Smith. Marshall and Keynes talked about it, as did others. So we just rediscovered the wheel.

By the time I came to the School, research was pretty firmly entrenched in the quantitative approach; everyone used big surveys that included lots of numbers and data. I had a humanities background and had read a lot of Freud and I thought some of that stuff was pretty cool. So when I first started talking to John Howard, I tried to engage him by asking if he didn’t think there might be some important...
stuff going on under the surface—hidden motivations, repressed desires. He was pretty appalled at the suggestion. He couldn’t entertain the idea that consumers were anything but rational economic creatures who maximized utility and weighed pros and cons and made rational decisions and were logically consistent and motivated by getting the best value for their money. John’s view was typical for the day. Between 1965 and 1980 every consumer-behavior study done was essentially based on a rational economic model.

**Q. Is the rationalist model really so limiting?**

**A.** The rationalist model makes a lot of assumptions about the way consumers process information, to the point of overlooking feelings, hedonic responses and aesthetic appreciation. A researcher can ask a consumer to name the attributes he or she cares most about in a car. And that consumer can say, “good mileage per gallon, lots of space in the trunk, rapid acceleration,” and so on. All of those data can be put into a model, and the consumer's perception can be measured based on how important each of these attributes is to him or her. Up to a certain point this can help researchers explain a consumer’s preferences, but so much is left out.

Consumers’ emotional connection to the consumption experience, for example, weighs heavily on their preferences and the way they process information. Consumers aren’t totally irrational, of course, but social values—how they use the brands to relate to friends and family, what impression they make on others based on the brands they wear—are significant contributing factors to how and why they make decisions. There are also aesthetic concerns—does it smell good, is it beautiful? There are altruistic and ethical concerns—was any person exploited to produce this product, does purchasing this product help anyone?

Quantitative research is useful for exploring someone’s preference in, say, shampoo, insofar as money and ingredients are concerned, but not for understanding how it makes an individual feel—young, sexy, energized. A marketer cannot use quantitative methods to explain someone’s decision to go to a New York Philharmonic concert or the Metropolitan Museum of Art.

**Q. What else, if anything, has changed during your tenure here?**

**A.** I’ve always used a lot of aggregate data; instead of looking at individuals I often look at the average behavior of a group of people. Human subject review has complicated matters in recent years. I often don’t know the exact direction of much of my research until it’s underway, and it can be difficult to get timely approval to use human subjects. But the Internet has compensated for that to some degree. There are vast amounts of public and nonsensitive data that are pretty accessible. That has allowed me to shift the direction of my research along the way, as is necessary, and to collect aggregate data on patterns and trends with relative ease.

I find a lot of the decision-making studies in behavioral economics and the new brain research work that is coming out fascinating. Some of that work does things like use brain scans and monitor blood flow—it’s still pretty new. I’ll be interested to see how it evolves.

**Q. What's next for you now that you are retiring?**

**A.** I have a few projects I’m still working on but I hope to wrap those up soon. I would like to travel with my wife, Sally. I’ve got some interest in photography. I’ve got a novel in progress that I’d like to finish. I play the piano and the vibraphone. I might not be playing a concert at Carnegie Hall any time soon, but I certainly hope to get back into playing more often. And I’ve done a lot of research on music—if I can find the time I’d like to explore the real nuts and bolts of music theory, especially in jazz.

Morris Holbrook was the William T. Dillard Professor of Marketing at Columbia Business School. He retired in 2009 after teaching and conducting research at the School since joining the faculty in 1975. A fellow of the Association for Consumer Research, he is the recipient of a Distinguished Scholar Award from the Society for Marketing Advances and a Carol and Bruce Mallen Prize for Contributions to the Motion Picture Industry.
Many Happy Returns on Marketing
Q&A with Don Sexton

Measuring marketing ROI need not be elusive. Don Sexton explains how firms can measure and increase the marketing contribution to the bottom line.

Q. Why have companies struggled to measure marketing ROI for so long?
A. Marketing managers have tended to focus too much too long on trying to measure the impact of tactics with easy-to-understand measures that are of questionable worth. Click rates for Web advertising are easy to measure, but what do they really tell us? Or consider ad agencies doing copy testing with measures such as awareness that typically do not connect to long-run financial performance. The measures commonly used to evaluate marketing tactics are often easy to apply but provide little insight into marketing ROI, especially over the long run.

We should be focused on evaluating not just tactics but both strategies and tactics. Strategy is about positioning and targeting: positioning consists of what the company is providing the customer and targeting concerns to whom they are trying to sell. If the positioning is wrong and the target market is wrong, rarely can tactics alone save the day.

We should also be asking, what is the overall impact of all marketing activities—the positioning of the product or service, the targeting and all the tactics taken together, including communications, promotions, pricing and distribution. The solution to evaluating marketing ROI is to take a broad look at how marketing really drives the financial performance of organizations rather than narrowly focusing on specific tactics.

We can take that broader look by focusing on measuring perceived value—which I define as the maximum that the target customer will pay for a product or service. Perceived value takes you back to the basics of what marketing does. That's why I define marketing as managing perceived value.

Q. In your book you note surveys that show that neither financial managers nor marketing managers have much confidence in the ability of marketing people to predict next year's sales. How can that lack of confidence be countered?
A. First, we should reconsider the marketing models currently in use. Many models have become folklore and are perpetuated by marketing texts and professors and consultants, even though they have been shown to be conceptually unsound.

For example, the hierarchy of effects model is in every marketing text and is even promoted by some well-known consulting firms. The model posits that a customer starts by becoming aware of a product or service, then moves to knowledge about it, then to liking, then to preference, and eventually decides to buy. This process sounds perfectly reasonable but most research shows it works only in very specific situations: usually when a very important purchase is going to be made on rational grounds.

If I'm in a deli and I'm thirsty and see a brand of orange soda I've never had before, I'm probably just going to buy it. I'm not going to look at Consumer Reports to see what they say about that brand of orange soda. If I don't like it, I'll throw it away. If I like it, I'll buy another—it's very immediate and does not require a hierarchy of effects process. Yet the hierarchy of effects model continues to be taught in every marketing text and is even promoted by some well-known consulting firms. The model posits that a customer starts by becoming aware of a product or service, then moves to knowledge about it, then to liking, then to preference, and eventually decides to buy. This process sounds perfectly reasonable but most research shows it works only in very specific situations: usually when a very important purchase is going to be made on rational grounds.

Q. In a nutshell, what is CVA and how does it work in conjunction with perceived value?
A. CVA—customer value added—is the difference between the perceived value that a customer places on a product or service and the incremental unit cost of providing the product or service. Keep in mind that perceived value is not price; it's the ceiling on price—the maximum a customer is willing to pay.

If the perceived value is lower than unit cost then CVA is negative and the company is producing something that is not worth the cost of the labor, capital and the materials being employed. If CVA is negative, then the value to the customer is not greater than cost and the company is in trouble. If CVA is negative for a while, the company will go out of business.

You can estimate perceived value in a variety of ways. None are exotic techniques—all are well-known procedures: value-in-use, constrained choice models, multivariate statistics and judgment. One issue in evaluating marketing ROI is that some marketing managers are not as comfortable with statistical analysis as perhaps they can and should be.

All these methods estimate the maximum price someone is willing to pay for a product or service and also identify how much the brand contributes to that perceived value and how much different benefits contribute. If a customer values a courier service at $30, it's possible to evaluate which part of the $30 is due to the...
service’s brand, to their tracking service, to the courtesy of their employees and to their on-time performance.

Q. Design and communication are the more traditional purviews of marketing managers. Where do these fit in CVA?

A. CVA depends on perceived value which in turn depends on design and communications.

Always keep in mind that CVA also depends on variable costs and these variable costs include marketing costs such as promotions. But the main determinant of CVA from the marketing side is perceived value.

Perceived value depends on design and on communications. Design affects the actual value of the product or service. Communications ensures the customer knows the value the product or service provides.

Actual value is usually higher than perceived value because if a customer overvalues a product— in other words, if their perceived value is above actual value— then they probably will not buy that product again. If your perceived value for a restaurant was so high that you were willing to pay $100 for a meal but when you visited the restaurant the wait staff spilled soup on you and were surly, then you probably won’t go back because their behavior showed that the value you perceived for that restaurant was overly high.

Even if a product or service has high actual value, the customer may not award it high perceived value unless they know about the product or service. That depends on a company’s communications. The “Have You Driven a Ford Lately?” advertising campaign is a good example of how to fill the gaps between actual and perceived value in the customer’s mind. Ford had improved their product, but it still needed to fill the gaps and persuade people at least to check out a Ford automobile— which they did with their campaign.

Some companies make the mistake of running such a communications campaign without first improving their product. But the most creative campaign in the world will fail if a product’s actual value falls short of what the company says it is. Great advertising makes lousy products fail even faster.

Q. Why are you adamant that companies not use last year’s marketing budget to set this year’s marketing budget? How can a company use CVA for budget planning?

A. Many marketing models are based on sales histories of perhaps three to five years and may include variables such as ad spending, pricing and deals. Such models are used to estimate next year’s sales. Do companies really expect that the coming year will be similar to the past five years— especially when the environment is constantly changing, with new competitors and new technologies?

Instead of using sales over the last few years to predict next year’s sales, companies will have more useful information for their decisions if they identify measures that are leading indicators of revenue and contribution.

It turns out that perceived value can be shown— in theory and in practice— to be a leading indicator of revenue and, similarly, CVA is a leading indicator of contribution. In my work with one large consumer packaged goods firm, we found that perceived value predicted revenue and CVA predicted contribution, both with R-squared values of over 90 percent. An R-squared value of 100 percent would mean predicting with certainty so an R-squared value over 90 percent is excellent and was much better than simply trying to predict by using last year’s sales and contribution.

Unfortunately, many methods for evaluating marketing that are in common use in companies, such as using last year’s budget to predict next year’s performance, have become mechanical. The one argument for such mechanical techniques is that they are simple. Why? Because they do not require much thinking. Thinking is a barrier to trying new approaches because thinking may result in change, which is often anxiety-producing.

CVA requires that we sit down and really think about what we’re doing with our marketing, how we are satisfying customers and the impact on our financial performance. When we do that, we can evaluate how marketing drives ROI.

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Don Sexton is professor of marketing at Columbia Business School and academic director of the Columbia University Center for International Business Education and Research (CIBER).
Viral Marketing—Contender, or Just a Trend?

Word-of-mouth promotions can significantly outperform conventional campaigns, and online and offline interactions are both important for success.

Viral marketing is thriving: one recent analysis estimates that from 2001 to 2008 firms increased their spending on viral campaigns by twenty-fold. Viral campaigns—sometimes called word-of-mouth marketing—are attractive because they allow firms to get closer to consumers than traditional marketing tools by seeding sample products within a target group of potential customers. The payoff comes in increased sales and brand recognition when participants spread the word about a product.

“But there are a lot of things we don’t know about how viral marketing works,” says Professor Olivier Toubia. “Do viral campaigns work better than traditional marketing campaigns? Exactly how does word of mouth spread? How can a campaign be optimized?”

The rise of online social networking platforms may help answer some of these questions. Marketers are increasingly turning to sites that combine the connective features of social networking with product review, often building influencer communities that focus on niche groups, such as parents, women or teens. Firms offer previews of their products to members, and members provide direct, unfiltered feedback to firms. The sites can also help generate promotional buzz while allowing firms to measure interactions and track how recommendations move.

Yet many firms remain unwilling to experiment much. Toubia, Andrew T. Stephen of INSEAD and Aliza Freud ’03 convinced a cosmetics firm that it could gain valuable insights into the mechanisms of viral marketing by turning a launch campaign for a real product into an experiment using both old and new marketing tools.

The firm engaged SheSpeaks, a social media platform, to develop a viral campaign and distribute product samples to 10,000 of its targeted female community members. In addition to receiving a sample, community members also received coupons for discounts off future purchases of the product. At the same time, the firm ran full-page magazine ads and free-standing inserts (FSI) in newspapers, both with coupons.

By tracking codes unique to each tool, the researchers were able to measure and compare redemption rates. The viral sampling branch of the campaign outperformed the traditional campaigns by an impressive margin, returning a redemption rate 12 times higher than that of magazines and about 17 times higher than that of FSI.

Coupon redemption is only a partial measure of a campaign’s success, but Toubia points out that its advantage lies in allowing the researchers and the firm to compare across tools. “It may not be profit or long-term brand image, but we have the benefit of comparing apples to apples,” he says. The viral campaign also allowed the firm to learn more about product interest, effectiveness, whether the participants intended to buy or recommend the product and the impact of influencers’ recommendations on their peers.

One open question has been, who are likely to be the most active members of viral campaigns? Toubia and his coresearchers found that they could predict which individuals would be the most active in the firm’s viral campaign by creating a model from an earlier campaign (for a product from a different firm).

“What really differentiates the active members from the less active members,” Toubia says, “are their social characteristics, and those never depend on the product—how many people they talk to, and how influential their recommendations are with people.”

Once a marketer knows those characteristics, predicting influence in viral campaigns doesn’t really improve with additional information. And, Toubia says, the product matters less than the person when making such predictions. “Before we know the relationship to a product or their feelings about it, we can predict the most active members.”

Given the prominence of social networking and online activity overall, one of the big questions about viral marketing is whether most key interactions—recommended or discussing a product—happen online or offline. Participants in the viral campaign reported far more offline than online interactions. “Even though the online component was central to the campaign,” Toubia says, “online interactions appeared as an extension—not a substitute for—offline social interactions in the campaign.”

While the exact mechanisms might differ, Toubia says, “in today’s world of blogs, e-mail and Facebook, face-to-face interaction still seems to be prominent.”

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Olivier Toubia is the David W. Zalaznick Associate Professor of Business in the Marketing Division at Columbia Business School.
THE IDEA
To profitably manage their customer base, firms need to capture and analyze the dynamics of customer relationships over time.

THE RESEARCH
A good customer relationship management (CRM) tool tracks each and every touch point between the customer and the firm, including the exposure of customers to marketing campaigns.

Current CRM tools, however, often produce static segmentation, which assigns customers to different loyalty levels such as not loyal, somewhat loyal and very loyal. These tools are limited in their ability to capture dynamic segmentation—or how the firm’s marketing efforts influence the customer’s movement between those levels over the lifetime of a customer’s relationship with the firm.

Professor Oded Netzer, with coresearchers James Lattin and V. Srinivasan of Stanford University, devised an econometric model for an improved CRM tool that analyzes a customer’s history with a firm and recognizes customer movement between levels of loyalty in response to marketing efforts.

The researchers observed alumni donations at Stanford University over a period of 27 years, identifying three levels of loyalty based on the frequency of donations: dormant, those who never donate; intermediate, those who donate infrequently; and active, those who donate frequently.

Universities focus the majority of their marketing efforts, such as reunions and e-mails, on active alumni. The researchers’ results showed that active alumni are likely to donate frequently even when their attendance at events or frequency of contact from the school is low, suggesting that increased efforts to cultivate this group would not lead to additional gains. Alumni in the intermediate state are more likely to donate after an interaction with the university—when interactions increase, so do their frequency of donations.

By capturing dynamic segmentation, firms can avoid misdirecting marketing efforts and can, instead, target the optimal customer—one whose loyalty can increase with targeted marketing efforts.

PRACTICAL APPLICATIONS
Marketing Managers
You can use this enhanced CRM tool to better understand your customers’ level of loyalty over the lifetime of their relationship with your firm. This allows you to determine your customers’ expected loyalty dynamics and assess which customers have the most potential to increase their loyalty and which marketing efforts should be used to target them.

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Oded Netzer is associate professor of marketing at Columbia Business School.
The Price of Competition
Antitrust laws aim to protect consumers and spur innovation by fostering competition, but in some industries ingenuity thrives under monopolists.

In 2005, microprocessor developers Advanced Micro Devices (AMD) and Intel became entangled in one of the most significant antitrust lawsuits since United States v. Microsoft. When the U.S. Department of Justice sued Microsoft in 1998, the case hinged on whether Microsoft’s bundling of Internet Explorer, its Web browser, with the Windows Operating System monopolized the browser market. (The case took a number of turns and was ultimately settled out of court.)

In Advanced Micro Devices v. Intel Corporation, AMD claimed that Intel used exclusionary and predatory practices—such as paying a portion of the distributors’ advertising costs and providing other incentives to broker exclusive deals—to monopolize the market for x86 microprocessors, which both firms manufacture.

The lawsuit sparked a series of investigations by the Federal Trade Commission (FTC), the New York State Attorney General, and the Korea Fair Trade Commission, among others. In May 2009 the European Commission fined Intel $1.45 billion for what it determined were illegal practices that stifled innovation and consumer choice. The lawsuit was scheduled to go to trial in 2010, but in November 2009 Intel agreed to pay AMD $1.25 billion to settle the dispute. Many industry experts expected the FTC to ease its investigation in light of the settlement, but in December the agency sued Intel, alleging that consumers have been hurt by Intel’s anticompetitive practices.

Lawmakers enforce antitrust laws to protect consumers and ensure that the nation remains technologically advanced by preserving competition, which is widely believed to foster innovation. Between 2000 and 2003, for example, the U.S. Department of Justice and the FTC challenged 109 mergers; in 41 of these cases, they cited slower projected innovation rates as the reason for challenging the mergers.

But economists and lawmakers have long questioned whether competition fosters or stifles innovation. Six decades of research on the question has proved inconclusive, Professor Brett Gordon says. “Much of the theory tells conflicting stories, and past empirical work has been plagued by data and measurement problems. Yet this inconclusive research is all lawmakers have to look to when making policy decisions.”

AMD and Intel’s conflict intrigued Gordon, prompting him to search for a better way to answer the question of whether competition helps or hurts innovation. “In this industry, Intel has been a near monopolist, and AMD second, for a long time,” he says. “And a lot of people in the industry believe that competing with AMD has actually fueled Intel to innovate at a faster rate.”

Working with Ronald Goettler of the University of Chicago, Gordon studied the dynamics between the two firms and developed a mathematical model that allowed the researchers to predict Intel’s behavior if it were the sole microprocessor developer in the industry. The researchers were particularly interested, Gordon says, in determining the rate of technological innovation and whether consumers would be better or worse off if Intel had no competitors.

To capture the competitive dynamics between the two microprocessor developers, the researchers compiled 12 years of data from both firms on sales, prices, research-and-development expenditures and production costs. First, the researchers fed the data into their model to establish a baseline level of innovation with both firms competing in the market. Next, they ran only Intel’s data through the same model to predict its rate of innovation if it was the only player in the field.

“There is all of this conventional wisdom that says competition is good for innovation,” Gordon says. “But, our model indicates that Intel would innovate more rapidly if it weren’t competing with AMD.”

Why? First, as the world’s only microprocessor developer, Intel would have increased pricing power in the market, allowing it to charge more for its products. The increased profit margin would allow Intel to invest more money in research and development, which would result in a higher rate of innovation.

Second, as the sole microprocessor developer, Intel could potentially put itself out of business if it didn’t innovate often enough. If, for example, Intel sold a microprocessor today, it is unlikely the same customer would purchase another microprocessor unless the new processor was more technologically advanced. This provides another incentive for Intel to innovate rapidly.

“Not surprisingly,” Gordon says, “we found that consumers are willing to pay higher prices and upgrade regularly for products that offer sufficiently better service and are more advanced.”

Gordon’s research is unique to the dynamics of the competitive relationship between AMD and Intel—a duopoly. Still, Gordon cautions that his findings indicate a discrepancy between conventional wisdom—the idea that competition promotes innovation while monopolies stifle it—and the fact that the rate of innovation differs based on several factors, including dynamics unique to each industry and how many firms are in play.

“The relationship between competition and innovation varies considerably by industry,” Gordon says. “We recommend the FTC and lawmakers study and evaluate each industry individually to help tailor their understanding of that industry’s unique competitive dynamics.”

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Brett Gordon is assistant professor of marketing at Columbia Business School.
How Not to Think Like a Media Mogul
Q&A with Bruce Greenwald

In a new book coauthored with Jonathan Knee and Ava Seave, Bruce Greenwald explains why performance suffers at so many big media conglomerates and which media firms will succeed in a changed media landscape.

Q. What is the curse of the media mogul?
A. The curse is that there is a huge amount of accepted conventional wisdom articulated by moguls who preside over information and entertainment companies. They have a flashy insight about something and then help generate opinions that have nothing to do with reality. The result is that whenever these moguls have implemented their insights without the constraint or discipline of other people closely questioning them, their performance has actually been pretty bad. Some are very talented people who do some things intelligently. But when they do things unintelligently, nobody stops them.

Q. You say that doomsayers predicting the death of media go too far. But you also question why anyone thought that the Internet was ever going to be the friend of media companies. Why is that?
A. The Internet is a friend of the consumer. It enabled lots of people to get to individual consumers. It makes it easy for competitors to get in the markets. And more customers are much better for consumers and much worse for producers and suppliers.

Q. The moguls — and a lot of other people — didn’t understand the dynamics of competition and they extrapolated from immediate experience. They just thought they were going to save a lot of money and reach a lot more customers. They didn’t consider that everybody else was going to be able to do the same thing. And it’s the “everybody else that can do that, too” that will kill you every time.

Q. Why do you say that the media mogul gospel — and the conventional wisdom — that growth and globalization are always good needs debunking?
A. Local communities have local cultures and they have local information needs that must be fulfilled. As the Internet has enabled people to do more customized stuff they have provided for it locally. If you don’t understand that and you start to pursue global platforms you’re just asking for trouble.

Q. What distinguishes a great media asset from a lousy media asset?
A. A great asset is a monopoly media asset. The more central you are to people’s needs the better you do. It’s like the old newspapers. Nobody was going to get in to compete against them and everybody needed them. And, still, nobody is going to compete against newspapers qua newspapers, but nobody needs them anymore.

Content production is never a great asset unless you are the only one doing it — and that’s just not going to happen. There are no barriers to entry, so there will never be monopoly control of content.

In the past, networks and music companies created and distributed programs and music. TV and cable networks have done well and some continue to do well. But now that everything is distributed on the Internet there will be less and less ability to keep people out of the business of aggregating content and distributing it. So there’s not going to be much money in that.

The good businesses that are left are telephone and cable companies because in the end everything has to go over their pipes. Content providers are not going to be collecting the money. Aggregators are not going to be collecting the money. And the value of the pipes is going up and up.

Q. How can media companies balance the need to be efficient with the need to nurture the creative talent that it depends on?
A. They can’t. The creative talent is going to have to nurture itself. Media companies are going hire freelancers. A good talent is going to make money for a good talent. It’s going to be like
law school and medical school. You’re going to have to provide for yourself and hope that you can be someone who can differentiate yourself in the market.

It plays out the same every place. Thomas Friedman does great. Movie stars do great. If people still read books, authors would be doing phenomenally. It’s not good for no-name people.

It implies what you have increasingly in sports, which is a star system. It used to be you had thousands of minor leagues playing all sorts of cities all over the country. They didn’t do really well, but players had a living wage. It was a good job. Now you have these stars who make a ton of money and everybody else starves. And that’s what happens when talent gets immediate access over TV or the Internet.

Q. What kinds of media organizations will be profitable in the future? What characteristics do they share?

A. The efficient ones and the ones who own the pipes and, to some extent, the ones who dominate particular niches. Nancy McKinstrey ’84, the CEO of Wolters Kluwer, has talked about how they started off by offering broad generic information. Suddenly everyone else was offering that so the company couldn’t make money anymore. It had to offer more specific information, for example, bond information that is very local; there is only enough demand to support one provider.

The thing that is really going to be lost in this is communities. There used to be journalistic communities that you could join, and within the communities the big stars were nice to the little guys and there was a place for everybody. And if you can pick and choose your content producers you can’t have that kind of community because the public won’t listen to it as a whole.

I think the community-based professions and the professional ethos and the morale and the comforts of being part of a profession and community is mostly going to disappear. I think that’s not something anybody expected from the Internet. We expected it would create communities, not disaggregate them.

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Bruce Greenwald is the Robert Heilbrunn Professor of Finance and Asset Management in the Finance and Economics Division and director of the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School.

Jonathan Knee is adjunct professor of finance and economics and director of the Media Program at Columbia Business School.

Ava Seave is adjunct associate professor of finance and economics at Columbia Business School.
A Shortcut to Earnings

Investors can look to a firm’s effective tax rate to yield clues to future earnings.

Investors spend hours poring over SEC filings and financial statements seeking clues to the value and future financial performance of firms. The most sought-after items are those that assist in predicting future earnings and/or share prices, but that may have been traditionally overlooked by investors.

Professor Andrew Schmidt may have uncovered one of these oft-overlooked earnings signals. Schmidt observed that many firms described changes in their effective tax rates (ETRs) to explain changes in earnings per share (EPS), which suggested to him that managers think ETR information is value-relevant. For example, in the third quarter of 2000, Hewlett-Packard (HP) lowered its year-to-date ETR by one percentage point, which increased EPS by over 3 percent.

Many investors view ETR changes as attempts at aggressive accounting or outright earnings management—often for that one percentage-point ETR change, HP’s EPS would have hit below analysts’ quarterly forecasts. But little attention has been directed at determining whether ETR changes can offer any clues to future earnings, and this is what Schmidt wanted to learn.

The ETR represents the amount of tax expense reported in the income statement divided by a firm’s pre-tax income. The statutory rate on corporate income is 35 percent, but the ETR often varies due to state and local taxes, specialized tax breaks like the research and development tax credit, lower tax rates on foreign income, financial reporting items like the deferred tax asset valuation allowance and tax-exempt income like municipal bond interest. These differences between the statutory rate and the ETR are disclosed in the ETR reconciliation of the income tax footnote in a firm’s quarterly and annual reports.

To learn about the relationship between future earnings and income taxes, Schmidt separated earnings into two parts, the change in net income assuming the ETR remained the same as the prior year and the change in net income due to the change in the ETR. Schmidt called this second component the tax change component, or TCC. In order to capture the most useful portion of the TCC, Schmidt took advantage of quarterly financial reporting requirements to further decompose the annual TCC into an initial and revised portion based on the first quarter estimate of the annual ETR.

Accounting rules require firms to compute quarterly tax expenses, in part, by estimating the ETR that is expected to be applicable for the full fiscal year. Interviews with tax and accounting professionals led Schmidt to believe that the items that would have the most persistent effect on management’s estimate of the annual ETR would be reflected in the initial (first quarter) ETR estimate. Estimates in later quarters, he determined, would likely contain stale information and reveal potential attempts at aggressive accounting.

Schmidt used quarterly and annual data from Compustat for almost 13,000 firm-year observations from 1994 to 2001 to test his ideas about ETRs and earnings. Using this data, he determined that the annual TCC was useful in predicting both future earnings and future stock returns. This result essentially debunks the notion that earnings due to ETR changes are predominately related to aggressive accounting. His results then show that the initial TCC was more useful than the revised TCC in forecasting future earnings, which suggests that the first quarter ETR estimate is much more useful in earnings prediction than later ETR estimates. Schmidt’s data also suggests that ETR changes have contributed to the mispricing of shares, which closer consideration of both tax-change components can help correct.

“In the past people viewed these earnings changes caused by ETR changes as one-off earnings-management techniques that have no implication for future earnings,” Schmidt says. “ETR changes were thought only to influence short-term earnings.” His work corrects that misperception.

“Investors should take a close look at firms’ tax footnotes because the ETR and the ETR reconciliation—which are mandated by the SEC—are there,” Schmidt says. “Even though the data suggests that the first quarter ETR estimate captures useful information, investors should consider paying careful attention to the information in the ETR reconciliation given the evidence of its usefulness in forecasting future earnings.”

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Andrew Schmidt is assistant professor of accounting at Columbia Business School.
Valuing Intangible Assets

Look to a firm’s income statement to gauge the value of its intangible assets.

Accounting has not kept up with the changing pace of business.

In a new white paper, Professor Stephen Penman counters that charge, and provides evidence that income statements are the best source for deciphering the value that intangible assets bring to the bottom line. “If the earnings from the intangibles are coming through income statements, then you can get the value by looking at the earnings. There is no compelling reason to book these intangibles to the balance sheet,” he says.

In one example, Penman uses a recent financial statement from Microsoft that illustrates how value can be traced through the income statement to provide a picture of a firm’s value. In 2008, Microsoft’s book value was $36.3 billion, while its shares were trading at $25, for a total value of $228.8 billion. The high market-to-book ratio (the ratio of the total value of outstanding shares to book value) of more than six means the market sees a lot of assets missing from the balance sheet. Microsoft is a fine example of the modern firm that reflects the shift in value from tangibles to intangibles.

Microsoft’s income statement reported a net income of $17.7 billion for 2008. Using information from the income statement, Penman employed a simple residual earnings valuation technique to calculate the equity value of expected earnings for 2009, arriving at a share price of $23.03 — much closer to Microsoft’s share price of $25 at the time than a look at the balance sheet (absent market share, intangible R&D assets or brand) would suggest.

“If you used the same technique on Microsoft in 2000 when it was trading at $60 — a bubble price — you’d understand that the market was overpriced at the time,” Penman says. “The earnings weren’t justifying the difference from the balance sheet that the market imputed.”

However, not all intangibles can be valued by looking at the income statement. Certain intangibles don’t contribute to earnings, and booking such assets would violate the principle of conservatism. “Speculative value is just that — speculative,” says Penman, “and should not be included anywhere in the accounting, balance sheet or income statement.” For example, a new drug that has not yet secured FDA approval cannot generate income at present, however much potential it may have. Similarly, a newer firm or entrepreneurial start-up may have intangible value, but not for the accountant to record. “A
start-up company might have a lot of entrepreneurial potential from its ideas," Penman says, "but there is no identifiable value until earnings show up on the income statement. Ideas are important, but ideas have to attract customers."

Just as some intangibles are not reflected through the income statement, neither should they be forced onto the balance sheet — a practice some experts advocate. "Trying to put an estimate of the value of an unapproved drug on the balance sheet is a risky undertaking," Penman says. "What if the drug doesn’t ultimately get approval? You must have objective evidence before booking assets, so you don’t just get caught up in booking speculation in the accounts. Values on the balance sheet have to be amortized. But since individual intangible assets can’t be pegged to a market price, what amortization rate are you going to use on the balance sheet? You introduce guesses and lose information, and you destroy the earnings information you would otherwise have."

Penman’s recommendations underscore how intangible assets work together rather than as individual revenue streams to generate income: an entrepreneurial idea can’t work independently of a brand or a marketing strategy. Intangible assets do not have stand-alone value, but earnings do report the value from using assets together.

"Coca-Cola’s value comes not just from the brand it created, but how the brand works in combination with its distribution system. The brand is an intangible working together with other intangible ideas about how to get value from customers. What if Coke sold off its brand? All the other intangible assets — like its distribution systems, and even tangible assets such as bottling facilities — would be worth far, far less than they are with the brand intact," Penman says. "You cannot isolate the value of individual intangibles."

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Stephen Penman is the George O. May Professor of Accounting and codirector of the Center for Excellence in Accounting and Security Analysis (CEASA) at Columbia Business School.
In the late 1970s, inflation began to run rampant, and Federal Reserve chair Paul Volcker led the central bank into an era of monetary-policy experimentation designed to curtail the rapid rise in prices. Volcker made a number of moves in quick succession, targeting money growth, increasing the federal funds rate by 3 percentage points in March 1980 and then cutting it by more than 7 percentage points between April and July of that year. The annual inflation rate peaked at 13.5 percent in 1980; by the end of 1983, it had returned to a relatively tranquil 3.2 percent.

In that the Fed’s policy experiments had the intended effect, the period of experimentation from 1979 to 1983 was successful. But it was a wild ride for investors as the Fed’s actions, coupled with the looming questions of whether inflation would retreat and for how long, stoked investor uncertainty. U.S. bond prices and yields fluctuated dramatically, and bond investors eschewed what they viewed as riskier long-term bonds, driving down prices. Instead, investors flocked to the safe haven of short-term bonds, driving those prices up and yields down.

To understand how inflation might move and how it shapes bond prices and yields—their term structure—economists try to model future inflation. Term structure is typically attributed to three factors: expected inflation, expected output growth (the increase in goods and services produced) and the inflation premium.

The inflation premium has typically been thought to reflect the reduced price and increased yield an investor typically requires to offset the risk associated with investing in bonds. For example, when future inflation is expected to remain stable or to increase at a slow, steady rate, an investor might be willing to pay 60 cents now for a 10-year bond that will pay one dollar in 10 years; should the outlook on inflation become more volatile, the price of long-term bonds might shrink from 60 to 50 cents—a premium of 10 cents, or almost 17 percent—to offset the risk posed by volatility.

But, Professor Maxim Ulrich says, “projections of current term structure models don’t account for the fact that it is impossible for investors to know the true statistical distribution of future inflation. At best, inflation models reflect approximations about that distribution.” This suggested to Ulrich that risk might not be the only factor contributing to the inflation premium.

Ulrich theorized that during times when inflation was very volatile, such as the experimental era of the early 1980s, investors would require a premium not only to offset inflation risk, but also to offset inflation ambiguity and, in particular, ambiguity resulting from the possibility that the Fed might not want to fight inflation. An ambiguity premium might exist distinct from (and perhaps be hidden within) the inflation risk premium.

To test this theory, Ulrich built a nominal term structure model that accounted for this suspected ambiguity premium, in part by introducing investor uncertainty about the true statistical distribution of inflation into calculations of bond pricing. Previous models assumed that the statistical distribution of inflation is known; in Ulrich’s model, the investor

Accounting for Inflation Ambiguity

New research reveals that bond investors extract a premium not only for risk but also for uncertainty.
is uncertain about the future inflation process, which more closely reflects reality. Ulrich plugged in U.S. data over a 30-year period and found that bond prices generated by his model closely correlated with actual bond prices over the same period.

to achieve this would be to adopt inflation targeting, setting explicit inflation goals as a way to keep inflation from rising or falling too abruptly and taking steps to try to insure that inflation stays within those set bounds. “When central banks can credibly commit to such goals,” Ulrich says, “ambiguity tends to remain very low because when the Fed embraces an official policy, investors are assured that the bank will take a variety of actions designed to keep the inflation rate in that target range.” While the exact rate of future inflation might remain unpredictable, the explicit commitment tells investors that inflation is likely to remain within a predictable range.

The same is true of a monetary-policy rule called the Taylor rule, which provides guidelines for how much the nominal interest rate should change in response to GDP and inflation. The Fed has not explicitly adopted the rule but frequently acts in accordance with its prescriptions. To complicate matters, the Fed’s apparent hesitation to adopt inflation targeting and the Taylor rule has not stopped it from taking many actions that aim to keep the annual inflation rate in the 2 to 3 percent range. But unless the Fed makes an explicit commitment to officially adopt inflation targeting or the Taylor rule, investors will remain uncertain about which actions the Fed can reasonably be expected to take. That lack of certainty, especially when financial markets are volatile, is likely to ensure the persistence of an ambiguity premium in bond prices. Ulrich’s work supports the common notion that if the Fed increased its efforts to communicate the rules and factors that constitute its inflation-control efforts, then investors’ inflation uncertainty would decrease and consequently help to suppress the inflation-ambiguity premium. In the meantime, Ulrich says, it’s best for investors to acknowledge the ambiguity premium when assessing bond prices and expected yields.

The results confirmed that during times of high inflation uncertainty an inflation-ambiguity premium comes into play and can be distinguished from the inflation risk premium. During the inflation scare period of 1983–84, U.S. long-term bond rates increased dramatically, although inflation remained constant at 4 percent. Ulrich’s model attributes the increase in bond rates to a rising inflation ambiguity premium, a finding consistent with the generally accepted perception that inflation scares are periods of high inflation uncertainty and strong skepticism about the Fed’s future inflation policy.

Ulrich was also able to show that the inflation-ambiguity premium disappeared when inflation uncertainty dropped during the Great Moderation — a period beginning in the mid-1980s marking a decline in the volatility of a number of major economic indicators. Overall, the presence of the inflation-ambiguity premium suggests that uncertainty must be taken into account as a factor distinct from risk when considering the term structure of bonds. The ambiguity premium also helps to explain the flight to quality — investors prefer to hold short-term Treasuries instead of long-term Treasuries during periods of high ambiguity to offset uncertainty.

The Fed could exert some influence over the ambiguity premium and effectively keep it in check, Ulrich suggests. One way says, “ambiguity tends to remain very low because when the Fed embraces an official policy, investors are assured that the bank will take a variety of actions designed to keep the inflation rate in that target range.” While the exact rate of future inflation might remain unpredictable, the explicit commitment tells investors that inflation is likely to remain within a predictable range.

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Ulrich’s work supports the common notion that if the Fed increased its efforts to communicate the rules and factors that constitute its inflation-control efforts,
How Fast Do Prices Move?

New research sheds light on the role monetary policy plays in the movement of prices and in stabilizing the economy.

The economists Adam Smith and Milton Friedman both argued that prices are largely flexible, moving so quickly that the economy is bound to balance day-to-day volatility on its own long before government intervention—such as Fed actions on monetary policy—can. But John Maynard Keynes argued that prices move slowly and that monetary policy does have a key role to play in stabilizing the economy by stimulating or slowing growth.

The debate has become more nuanced over the last 10 years as economists have learned in greater detail how prices move. Aggregate prices—the averages for all prices in the economy as a whole—are indeed sticky. But in each sector, prices can move quickly and vary greatly depending on the kinds of shocks affecting a particular sector at any given time.

Professor Marc Giannoni worked with Jean Boivin of HEC Montreal and Ilian Mihov of INSEAD to reconcile the apparent contradiction that prices are both sticky and flexible. Does monetary policy simultaneously affect a large number of sectors? Or do sector-specific prices respond slowly when the Fed changes interest rates even though they respond very rapidly to sector-specific shocks?

While many sectors experience idiosyncratic shocks that create a lot of volatility in the sector, that volatility might not be reflected in overall prices because it gets offset by volatility in other sectors. “Prices can be extremely volatile in each individual sector,” Giannoni explains, “but on average prices remain very stable.”

If changes the Fed makes to interest rates have the same impact on prices that sector-specific shocks have, that implies that Fed actions would have a big impact on prices but not a lot of impact on economic activity. In that case, the Fed would not be able to stimulate growth during a recession—or to slow overheated expansion in an upturn in an effort to control inflation.

The researchers looked at a broad range of key economic indicators between 1976 and 2005, including consumer and producer price indices, industrial output, interest rates and employment figures across sectors. Rather than focus only on aggregate prices, the researchers looked at the characteristics of prices that made them so sensitive—were prices changing in response to macro disturbances, including shifts in monetary policy, or something else?

By developing a statistical framework that distinguished sector-specific changes in prices from price changes in the aggregate, the researchers were able to see how different sectors moved in relation to macro shocks or sector-specific shocks.

The framework was built on the assumption that prices are driven by two sets of components: a set of macroeconomic components such as the effects of policy, aggregate demand shocks (reflecting, for instance, an increased willingness of consumers to purchase products), supply shocks or oil price shocks, and a set of components that reflect variable conditions unique to a sector. For example, the weather might drive the price of vegetables but not the price of watches.

The researchers found that individual sector disturbances tend to be large and do have rapid effects on prices. For example, vegetable prices frequently fall or drop from day to day by as much as 20 percent depending on conditions in the agricultural sector.

But prices also respond to macroeconomic disturbances in a very different way: the researchers found that it’s only after several months that monetary policy starts affecting prices in most sectors.

The upshot is that monetary policy does have a key role to play in moderating the economy. “Since most sectoral prices don’t respond immediately to monetary policy actions,” says Giannoni, “monetary policy can affect economic activity in those sectors for a long period of time.”

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Marc Giannoni is the Roderick H. Cushman Associate Professor of Business in the Finance and Economics Division at Columbia Business School.
Living Longer and Prospering, for Less

New drugs and medical procedures account for much of the increase in the longevity of Americans—and haven’t increased the cost of care.

In the last century, life expectancy at birth in the United States has risen impressively, from more than 43 years in 1900 to 77 years in 2000. Life expectancy has continued to grow in the last 15 years, but the increase has varied considerably across states, from one-third of one year in Oklahoma to more than four years in New York.

Doctors and other healthcare professionals are surely interested in accounting for the growth in life expectancy and the disparities between states. Economists too are increasingly interested in investigating longevity. These dynamics are particularly critical given that healthcare reform sits high on the U.S. domestic agenda.

For decades, per capita GDP was the standard unit by which economists measured economic growth, long held to be one of the most important benchmarks for quality of life. Suspecting that GDP may be too narrow a definition, many economists are now starting to consider other measures that might more fully reflect growth. For example, the World Bank’s Human Development Index calculates economic prosperity by looking at life expectancy and educational attainment along with per capita GDP.

“If quality of life and well being depend not just on income as generally measured but also on life expectancy and education,” says Professor Frank Lichtenberg, “what accounts for growth in life expectancy?”

To answer this question, Lichtenberg culled state and national data to look at a far-reaching set of factors, including mortality, income, education, health insurance status and behavioral risk factors including smoking and obesity rates. He also used Medicaid and Medicare data.

Lichtenberg paid particular attention to the introduction of new drugs and diagnostics. Many health economists believe that medical innovation has played a crucial role in improving health. “One hundred years ago, increases in longevity were probably due to things like improved public health and sanitation,” Lichtenberg says. “Now the main sources of longevity gains are new medical products and procedures. New drugs are an important part of that.”

Innovations are also regarded as drivers of economic growth. “The consensus is that science and technology and the new products that come from them are key. It’s well-established when you look at conventional growth measured in terms of GDP,” Lichtenberg says. “I see no reason why this wouldn’t apply to healthcare as well.”

Lichtenberg did find that a substantial proportion of recent increases in U.S. life expectancy can be attributed to the use of medical innovations. He also found convincing evidence that quality of care was responsible for the state-by-state differences on three different counts. Life expectancy increased more rapidly in states where the fraction of advanced procedures increased more rapidly; where the vintage (or FDA approval year) of drugs increased more rapidly; and where the quality of medical schools attended by physicians increased more rapidly. (Looking at where physicians went to medical school as one measure of quality of care was a novel aspect of Lichtenberg’s research. The better the school, Lichtenberg theorized, the greater the likelihood of better patient outcomes.)

One surprising outcome, says Lichtenberg, is that the data did not reveal any correlation between per capita income growth and growth in life expectancy. “It is certainly true that higher income people and more educated people have higher life expectancy than less educated people, so you might expect to observe at the state level over time that where average income is growing fastest, higher rates of longevity would also be observed.”

Yet that’s not the case. “It is at odds with the micro-evidence at the individual level,” Lichtenberg says. However, micro-evidence has its pitfalls. “If we observe a high positive correlation between wealth and health, that could mean that wealth is causing the health, but it could also mean that healthier people simply have a greater capacity to earn.”

Lichtenberg also surfaced some unexpected findings about health insurance. There does not appear to be a correlation between health insurance coverage and life expectancy. Even as the number of insured Americans has dropped in the last eight years, there is no correlation between that drop and a growth in the mortality rate. However, Lichtenberg acknowledges that there is a somewhat tangled relationship between insurance and health. “It’s complicated because healthy people, especially younger people, may self-select out of healthcare when they have the choice.”

In states where health insurance coverage was expanding, health expenditures were not growing as fast as they were in states where coverage was contracting. “That may seem surprising, since the assumption is that those with insurance might go to the doctor more often and take better, more costly prescription drugs,” Lichtenberg acknowledges. “But there is a lot of evidence that people who lack insurance get care in a costly and inefficient manner.”

Significantly, states in which the quality of care was increasing the most did not experience larger increases in per capita medical spending. In other words, improving quality of care has increased longevity without costing more. Given this, Lichtenberg says, “improving the quality of medical care should be the primary objective of healthcare reform.”

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Frank Lichtenberg is the Courtney C. Brown Professor of Business in the Finance and Economics Division at Columbia Business School.
How Big Is the Social Security Shortfall?
Adjusting for risk provides a better way to measure the value of future benefits.

By the time today’s youngest generation of workers retires, Social Security will likely face a deficit in the trillions of dollars. Most experts agree that the system needs an overhaul. But first, policymakers need a way to measure the extent of the shortfall.

The Social Security Administration (SSA) measures the financial health of the system by estimating future cash flows (benefit payments and worker and employer contributions) and discounting them into today’s dollars, to arrive at a measure of present value. But what discount rate should be used? The government currently uses a rate that makes no adjustment for risk: the yield on riskless Treasury bonds. But Social Security cash flows are not riskless, says Professor Stephen Zeldes. Ignoring that risk leads the SSA to use too low a discount rate, producing an inaccurate measure of Social Security’s present value—and of its long-run health.

Social Security benefits are wage-indexed: payments are based on an individual’s earnings history and the average national wage in the year that the individual turns 60 years old. Those who have the good fortune of turning 60 in a year in which wages are high will have higher benefits. In subsequent years, benefits are adjusted for inflation, but not for wage growth. Because the average wage fluctuates over time, any valuation of future benefits should account for this risk, Zeldes argues.

Zeldes and John Geanakoplos of Yale University have proposed a way to account for market and wage risks. They first ask, if cash flows were traded as securities on financial markets, what would their market prices be? To determine this, they first propose creating a wage bond, a security tied to the average national wage that when it matures would pay an amount equal to the average national wage that year. They use asset pricing methodology to determine what the discount rate and market value of these bonds would be. Since Social Security cash flows are closely related to those of wage bonds, the prices of the wage bonds can be used to compute the market value of Social Security cash flows.

Pricing wage bonds is not an easy exercise. Research has shown a positive long-term correlation between average wages and stocks. “This means that distant payoffs on wage bonds will tend to be low if the stock market has performed poorly and high if the market has done well,” Zeldes says. To price wage bonds, Zeldes and Geanakoplos developed a model that links wages, dividends and stock prices. The model accounts for specific behaviors of the economy and markets and also draws on common techniques used to price derivatives. Using this model, the researchers came up with an appropriate discount rate for valuing future cash flows.

“It’s fine to use close to a risk-free bond rate to discount Social Security benefits that will be received in a couple of years, because the short-run riskiness of wages is low,” Zeldes says. “But for benefits in the distant future, the discount rate should be much higher than the one now used by the SSA. Our model shows that the rate should be much closer to the rate that would be applied to stocks.”

The researchers apply their methodology to estimate the maximum transition cost. This equals the present value of all benefits that have been accrued to date, minus the current value of the Social Security trust fund. In other words, the maximum transition cost indicates how much extra money the trust fund would need, if the Social Security system were shut down today, in order to ensure payment of all benefits already accrued as a result of past earnings. Applying the SSA methodology that ignores risk yields an estimated gap of about $11.1 trillion. “But we find that the risk-adjusted market value of this gap is about 23 percent smaller than this, i.e., only about $8.6 trillion,” Zeldes says. “This means that the cost in today’s dollars of paying future benefits is not as high as most people perceive it to be.”

In ongoing work, Zeldes and Geanakoplos are examining other measures of Social Security financing gaps, including ones that take into account future tax contributions. In addition to changing the way the system is measured, Zeldes and Geanakoplos would like to transform the system itself and, to that end, have proposed a system called Progressive Personal Accounts. “Our plan incorporates market mechanisms into Social Security yet also maintains and even improves on the protection and safety provided by the current system,” Zeldes says. “Social Security is generally well designed, but there are some fundamental changes that could make it even better.”

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Stephen P. Zeldes is the Benjamin Rosen Professor of Finance and Economics and academic director of Columbia CaseWorks at Columbia Business School.
Keeping Up with the Joneses
How habit and peer influence affect the appetite for risk.

Historically, stocks have produced greater returns than bonds, yet many investors have consistently shied away from stocks. In the long term, looking beyond the current recession, such prudence seems counterintuitive: average annual returns on S&P 500 stocks approached 12.5 percent between 1950 and 2008. During the same period, average annual returns on short-term bonds hovered around just 5 percent, while average annual returns on long-term bonds were just over 6 percent.

Economists have traditionally attempted to explain why so many investors steer clear of stocks by assuming that those investors simply have very high levels of risk aversion. But some experts view such levels of risk aversion as unrealistically high.

More recently, some economists have taken a different approach using habit persistence models. In this newer view, investors’ choices, including their attitudes toward risk, are motivated by their own typical level of consumption (internal habit) and how that compares to that of their peers (external habit). A fast-food lunch gives much less pleasure to someone used to lunch in upscale restaurants than it does to someone used to fast food; a fast-food lunch falls below the threshold of her normal experience. Similarly, the pleasure or usefulness a person gets from a new handbag or TV depends in part on whether she views her purchases as measuring up to those of her peers.

Because of this dynamic, people tend to change their consumption behavior relatively slowly in response to actual or expected changes in income: a relatively poor person who inherits a lot of money is unlikely to immediately and drastically increase his spending. Instead, as he becomes increasingly comfortable with his newfound wealth, his spending will gradually increase.

When it comes to losing money, the dynamic shifts: the closer an investor finds himself to his own benchmark, the more he views himself as at risk to fall below it, and the more sensitive he becomes to risk. Once his net worth drops enough to threaten the lifestyle he’s accustomed to, he becomes much more conservative in his investing behavior.

Economists have looked to macro-data for an explanation of the connection between habit persistence, fluctuations in consumption and risk tolerance, and overall risk aversion, with mixed results. Professor Enrichetta Ravina, whose research interests include credit markets, behavior and household finance, turned to micro-level data for a clearer picture of the relationship between household consumption and investor behavior.

Ravina examined the consumption habits of 2,674 households in California over three years, using the credit card spending of individual households to assess their consumption benchmarks. To examine peer influence, Ravina looked for households in the same zip code that had quickly and noticeably increased their consumption, but whose income hadn’t increased. She then reviewed lottery winner data to see if that particular zip code had lottery winners of prizes of $200,000 or more. She found that households whose neighbors’ consumption increased the most were spending more than an otherwise similar individual, even after adjusting for other factors, including differences in the price of goods in the area, unemployment and house prices.

Unlike macro-data, micro-data offers the advantage of accounting for differences in consumer spending based on the unique financial circumstances of individual households, that is, whether each had more or less debt, access to additional credit and savings. After accounting for those factors, Ravina was able to identify strong evidence that both the personal consumption and peer spending benchmarks informed habit persistence in the sample and that both benchmarks factored into spending choices to a high degree.

Ravina translated these findings into a model of risk appetite and compared that risk appetite in the business cycle, finding that when uncertainty increases and investors experience significant negative wealth shocks, as they have recently, they exhibit disproportionate risk aversion. “Since investors’ consumption benchmarks and their relative positions compared to their peers are now at risk,” she says, “they become extremely conservative in their investments, shying away from stocks.”

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Enrichetta Ravina is assistant professor of finance and economics at Columbia Business School.
Putting the Brakes on Collateral Liquidations
How can creditors protect themselves when a financial institution defaults?

When Lehman Brothers collapsed in fall of 2008, its creditors quickly moved to sell their portion of the institution’s collateral assets. This large-scale fire sale drove down the assets’ prices, further fueling instability in financial markets.

It’s common for creditors to sell their collateral assets on the heels of a default, but when multiple creditors rush to sell, a classic coordination problem arises. “A creditor knows that as others sell, they will drive down the collateral assets’ price and if the creditor doesn’t join the race, it will suffer significant financial losses,” says Professor Martin Oehmke, whose research interests include asset pricing and financial intermediation.

The dynamic is more acute now because in the past few years borrowers have increasingly used illiquid assets as collateral in secured lending markets, such as the repurchase agreement market, which at roughly $12 trillion is one of the central hubs in the financial system. “Illiquid collateral can be difficult to convert into liquid assets, such as cash, and illiquid assets usually sustain noticeable price drops when sold,” Oehmke explains.

Slowly liquidating assets over time is the best way for creditors to minimize large drops in price, thereby maximizing proceeds. But a creditor may not be able to sell the collateral assets slowly if they cannot afford to hold the risky collateral assets on their balance sheet for an extended period of time. Further, when multiple creditors are in play, the competitive pressure builds and can make it impossible—even for creditors that have strong balance sheets—to afford the luxury of selling slowly. Because other sellers will drive down the collateral asset’s price, the best thing to do is to also sell quickly, resulting in a rush to sell. Prices might recover over time, but the initial drop can negatively affect the rest of the market.

“The best scenario is for creditors to cooperate with one another after a default and agree to liquidate slowly,” Oehmke says. “But that’s unrealistic because every creditor will act in its own best interest.”

Using tools from game theory, Oehmke developed a theoretical model to help understand the factors that drive the dynamics of collateral liquidations, including how quickly creditors are likely to sell collateral, the rate at which the price is likely to move during liquidation and the amount sellers are likely to recoup in a liquidation. Considering these dynamics prior to lending or when faced with a default can help creditors reduce the pressure to sell off assets quickly.

Creditor structure plays an important role in these dynamics. One of Oehmke’s key findings is that the race to sell can sometimes be averted when only one creditor has lent to a financial institution, as might be the case with small institutions that don’t need multiple sources of credit. But multiple creditors can take on more risk than a single creditor; when a lone creditor is responsible for all of a borrower institution’s collateral assets, a default can increase the creditor’s liabilities, weakening its balance sheet. Unless the creditor has an otherwise strong balance sheet that can compensate for the decreased value of the collateral assets, affording the creditor leeway to hold on to them, it will sell quickly, provoking a drop in price before all the assets have sold. Oehmke shows that ultimately, whether a liquidation is more orderly with single or multiple creditors depends on the nature of the collateral assets and the individual balance sheet strength of the creditors.

Oehmke also concludes that when setting margins for collateral assets, creditors should take into account the total number of lenders, illiquidity of the assets and how likely it is that a financial institution will default. A creditor who lends $800,000, for example, may consider these factors and conclude that it should require $1 million in collateral assets. With a secure margin, the creditor can hold onto the assets longer, sell them slowly and remain relatively unaffected as long as the value doesn’t drop below the amount of the initial loan.

“Creditors should consider the amount of risk they can bear during a liquidation should a borrower default,” Oehmke says. “Will they have enough risk-bearing capacity in the event of default?”

Another possible way to prevent a liquidation race is for a firm with a strong balance sheet to step in and buy the troubled assets in bulk, either holding the positions or liquidating them slowly. Last fall, for example, in a deal brokered by the U.S. government, Bank of America averted Merrill Lynch’s default by acquiring it and curtailing a mass sale of its collateral assets. Similarly, in spring 2008, the government intervened and prevented Bear Stearns’ default by brokering its sale to JPMorgan Chase. While both deals have garnered plenty of criticism, it’s likely that the actions averted the kind of massive dislocations and financial market panic seen after the Lehman default.

“Considering the dynamics of collateral sales prior to the default of a financial institution,” Oehmke says, “can help creditors make better risk management decisions and act in a more calculated fashion when they find themselves in a liquidation, preventing or limiting financial loss and spillover effects into the rest of the market.”

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Martin Oehmke is assistant professor of finance and economics at Columbia Business School.
THE IDEA
An easy-to-implement policy allows firms to determine the effect of future financing and performance milestones on pricing decisions, even when firms face uncertain market conditions.

THE RESEARCH
Lenders and investors impose sales milestones on developers of large-scale real estate projects to reduce their risk of default. For example, in some real estate markets it is typical for a lender to require that pre-construction sales of units cover 100 percent of the total loan amount. These milestones affect the pricing decisions made by developers and the project’s profitability. Similarly, a retailer’s impending quarterly payment of sales commissions might function as an informal sales milestone if it prompts sales staff to increase sales efforts in the final weeks before commissions are paid.

Assessing the effect of all future milestones to decide the best price to apply today can be formidable. How should a real estate developer, for example, adjust pricing to accelerate sales and secure the viability of a project, particularly in today’s uncertain market?

Professors Omar Besbes and Costis Maglaras studied how firms should best set their prices over time when facing sales or revenue milestones. Their analysis produced a practical and easy-to-use feedback tool that determines when prices are best increased or decreased to maximize a project’s lifetime profitability subject to the various milestones. Their tool uses an intuitive formula to combine up-to-date performance with all future milestones to decide whether prices should be adjusted, and by how much. The tool is effective even under highly uncertain market conditions, and can be used in real estate, retail and other industries engaged in selling a large number of units over a long time horizon. Most recently, it has been applied successfully in several residential developments in the South Florida real estate market.

PRACTICAL APPLICATIONS

Real estate developers, sales and marketing firms
You can use this research to identify how to optimally incorporate the effect of all downstream milestones into your current pricing decisions.

Lenders
You can use this research to make financial projections for large real estate projects, and to estimate the risk associated with such projects (or a portfolio of projects), when simulated against possible market scenarios. You can also evaluate the impact of the milestones imposed on developers and adjust your requirements to align with your institution’s objectives and risk preferences.

Investors
You can use this research to value portfolios of large real estate assets or assess a purchase price for a portfolio of assets given your own financing constraints, milestones and objectives.

Pricing and sales executives
You can use this research to assess the impact of incentive milestones on overall performance and the likely short-term pricing behavior of store managers as well as to design the appropriate sales incentives to best align sales performance with your firm’s profitability.

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Omar Besbes is assistant professor of decision, risk and operations at Columbia Business School.

Costis Maglaras is the David and Lyn Silfen Professor of Business in the Decision, Risk and Operations Division at Columbia Business School.
Liar’s Loans
How misaligned incentives between brokers, banks and borrowers encouraged widespread falsification on mortgage applications.

During normal times, the rate of mortgage delinquency is between 1 and 3 percent. By the summer of 2009, well into the credit crisis, the average delinquency rate on home loans was just over 10 percent. A handful of banks, the rate was about 25 percent.

While many explanations have been offered up to explain these disproportionately high delinquency rates, Professor Wei Jiang believes the best way to understand what went wrong is to look closely at micro-level data. Jiang worked with Ashlyn Nelson of Indiana University and Edward Vytlacil of Yale University to examine the documentation of more than 700,000 loans issued by one bank that recorded a 25 percent delinquency rate.

The bank provided data that included every piece of information recorded at loan origination—including address, reported income, length of time in a job and other similar data that lenders typically use to assess the credit-worthiness of mortgage applicants, a large field of data that allowed the researchers to determine how the bank made each loan position.

The researchers categorized each of the mortgages as either high-documentation (hi-doc) or low-documentation (low-doc), depending on the amount of supporting data accompanying the loan application. Across both categories, Jiang and her coresearchers found that the greatest delinquency rates came from the broker channel—loans originated by brokers were 50 percent more likely to be delinquent than loans originated by the bank. They also confirmed that brokers approached lower quality borrowers—people with lower income, lower credit scores and who live in poor neighborhoods.

But Jiang and her coresearchers found that while low-doc borrowers had higher rates of delinquency, the loan applicants actually looked better on paper than high-doc borrowers. “Low-doc borrowers had slightly better credit scores, slightly better incomes—slightly better everything,” Jiang says. “A look at documentation alone without considering the point of origin would not reveal a true sense of default risk, but a look at origination alone could provide a good sense of which loans are at higher risk of default.

Jiang says the problem with the low-doc loans is not necessarily a visibly lower lending standard. Rather, it’s the lack of verification of the numbers provided in loan applications. “Is there undisclosed debt? Is the job stable? Neither the bank nor its brokers held the application data to any standard verification test.”

The highly imperfect result of such laxity reflects a common economics problem. “When you delegate a job to someone else,” Jiang says, “that person doesn’t take your full interest to heart.” The interests of the bank and the broker are misaligned: the banker will eventually take on the loans as assets, but the broker’s incentive stops once the deal is closed and a commission is earned.

Consistent with this, Jiang found that correspondent brokers—those who contract through a single bank and thus have an interest in maintaining a good relationship with the bank—are far less likely than noncorrespondent brokers to bring in loans that later result in high delinquency rates.

A second pair of misaligned interests exists between banks and borrowers, who are not always motivated to provide accurate information to the bank. Jiang found that low-doc borrowers whose applications were not verified tended to exaggerate their income by about 20 percent: hence the higher the reported income the greater the likelihood of delinquency. (In a full-doc loan the reverse is true: the lower the reported—and verified—income, the greater the likelihood of default.)

The bank also applied lower standards to mortgages that were more likely to be secured. “People argue that a bank cares more about broker lending standards since the bank gets stuck with the loan permanently,” says Jiang. “But if a bank can sell the loan to the secondary market three weeks after it’s made, then the bank cares less about standards.”

In some sense, securitization makes brokers out of banks. And during the period of high securitization, in 2005–06, when the worst loans—with the highest default rates—were issued, lower standards were applied to mortgages, not only by brokers but also by the banks themselves. But buyers of securitized mortgages cherry-picked only the better loans, and banks eventually found themselves stuck with many of the most risky loans.

The industry standard is typically half bank-, half broker-originated loans, but the bank Jiang studied was 90 percent broker-based and 10 percent bank-based—explaining why the delinquency rates for the bank in Jiang’s study were so high above the industry norm. There are a handful of other banks whose mortgage default rates hover around 25 percent. Jiang suggests the same underlying numbers might be found in these other banks, because it is likely that they mostly relied on noncorrespondent brokers.

Given the problems associated with the broker channel, why would banks use brokers at all? “These banks all had more than 50 percent annual growth for three or four years,” Jiang says. “You cannot build branch staff that quickly; the only way banks could achieve that growth rate was to use the mortgage broker channel to hone in on marginal borrowers.”

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Wei Jiang is associate professor of finance and economics at Columbia Business School.
The Disaster Premium

Severe—but infrequent—drops in consumer spending may explain why stocks yield higher returns than bonds.

Why do investors hold relatively low-performing bonds even though stocks earn much higher returns over the long-term? The question is at the heart of the equity premium puzzle, or why stocks pay off at such a higher rate of return than bonds despite bonds’ popularity with investors, a paradox that economists have long sought to explain.

Professor Emi Nakamura believes that one such explanation may lie in consumption disasters, rare events in which a country experiences a large drop in consumer expenditures as a result of severe economic conditions.

Consumption disasters directly bear on asset prices because investors will pay a lot for assets that pay off in a down economy. Such assets thus effectively act as insurance. Since investors can’t be sure when a downturn will hit, how severe it will be or how long it will last, they play it safe by investing in bonds.

Investors’ assumptions about the frequency and duration of disasters bear heavily on what investors believe the return on stocks should be relative to less risky assets like bonds; riskier investments are expected to yield higher returns, at least during normal times. For the 20th century, the equity premium — the average difference between the return on stocks and bonds — is a substantial 7 percent.

To learn more about whether rare disasters explain the size of equity premium, Nakamura worked with Robert Barro and José Ursúa of Harvard and Jón Steinsson of Columbia University’s Department of Economics to identify some of the largest consumption disasters of the last 150 years.

Nakamura and colleagues used a newly available panel data set of consumer expenditures from dozens of countries, culled from a variety of sources across a number of academic disciplines, including history and sociology, and which reached as far back as 1850 (far earlier than previously available data). The researchers then created a model that effectively functioned as a disaster filter, plugging the new data into their model to identify which economic downturns in which countries qualify as large consumption disasters.

The filter sheds light on the severity and permanence of disasters. Consumption dropped on average by 35 percent in the disasters the researchers identified. The model’s disaster cutoff is so extreme that the Great Depression doesn’t qualify as a severe temporary and permanent disasters, and that disasters can develop over years.

“A world in which disasters are permanent is a much riskier world than one in which most countries recover from disasters,” Nakamura explains. “If investors thought that all disasters were permanent, the expected equity premium would likely double.” According to the researchers’ estimates, in a world without economic disasters, the return that equity would get over bonds is a tiny fraction above zero; when allowing for the 1.4 percent probability of a disaster happening — the actual probability suggested by the disaster filter — the equity premium shoots up, to close to 6 percent, far closer to the equity premium reflected in markets.

Economists have long understood the effect that severe market conditions have on asset prices, but until very recently there wasn’t enough historical data to back up the explanation. “If an investor believes there is a nontrivial possibility of a disaster happening — like what looks to be happening in Iceland, for instance, which the IMF forecasts will experience a 30 percent drop in consumption over the next few years, and would qualify as a disaster in our dataset,” Nakamura says, “this may have a dramatic effect on the willingness of investors to buy stocks, particularly because of uncertainty about how long and how bad the disaster could turn out to be.”

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Emi Nakamura is assistant professor of finance and economics at Columbia Business School.
Are Macro Changes in Store for Microlending?

Q&A with Suresh Sundaresan

New financial tools and technologies are poised to change the way microfinance is practiced, says Suresh Sundaresan.

Q. You open this book, *Microfinance: Emerging Trends and Challenges*, by pointing out that the high end of the microfinance ladder has embraced a number of innovations, while the lowest rungs have continued to work largely the same way through the years. What is driving the difference between the high and low rungs?

A. At the lower end of the spectrum, there are mostly women borrowers, who participate mostly in group lending. The average loan size is fairly small. Big institutions are less interested, because to put together a portfolio of two or three million dollars with an average loan size of $150, you really need to have thousands of loans. It was not a scalable proposition until very recently.

In the current structure, borrowers still participate in group lending and village banking and are being primarily served by NGOs, which are driven by soft capital. NGOs don’t worry about scaling up the same way banks or other largely profit-driven financial institutions do.

Q. What does the future hold in terms of scalability?

A. There have been two big developments. One is innovation in information technology. The ability to deliver loans through mobile phones means that if a lender can deliver a thousand-dollar loan from point A to point B separated by thousands of miles, that lender can just as easily deliver a $20 loan. The transaction cost is eliminated, so suddenly there’s the possibility of delivering loans through mobile phones into kiosks — very much like the system we have for delivering phone cards. That has already happened in the Philippines and has opened up the possibility for scalability for the lower end of the spectrum.

The second innovation is happening with BRAC, the Bangladesh securitization project. It’s a Grameen type of system — the loans are very small. Bangladesh is a small country, but it is waterlogged, with a lot of remote corners that are not well connected. BRAC manages by keeping meticulous loan records for every village. The data on loan performance for all these tiny loans were eventually computerized so that they could be aggregated into a fairly large portfolio. That portfolio was then securitized and assured a credit rating, and pension funds and others invested in it. So I think this and similar innovations in financial securitization and information technology hold big hope for scalability.

Q. Given that the credit crisis has been largely driven by securitization and CDOs, that is not exactly comforting. Why should microfinance be any different?

A. It’s true that these are precisely the strategies and instruments that are seen as the main culprits in the credit crisis. But in microfinance, for most of these borrowers, if they default or if they don’t service the loans, the outside costs of borrowing will become much, much higher. So they are very incentivized to avoid default. They are responsible to their borrowing group, and their reputation is at stake because their entire village will know if they default.

Contrast that with subprime borrowers, who can walk away from their loan, which is a non-recourse loan; the bank can only take over a home (now worth less) but cannot come after personal accounts or other property. The repayment incentives for a microfinance borrower are much more severe, and so the underlying risk for securitized microfinance products is much more reasonable than what we’ve seen with mortgage securitizations and CDOs here.

Also, if mobile-phone technology lives up to its promise, securitization might become less important. A poor borrower in Chennai can take delivery of a loan from a lender in Delhi, hundreds of miles away; as long as her credit history is in the mobile-phone system, the credit history can be transmitted to Mumbai or wherever she migrates for another job. She can find job opportunities and continue to service the loan, so it is not even necessary to aggregate these loans. We are still far away, but it could easily develop along these lines.

Q. What political and regulatory roadblocks have delayed the expansion of microfinance innovations?

A. There were problems getting BRAC running. Politicians delayed the project for different reasons. First, infrastructure: the borrowers were dispersed throughout remote villages without computer records, and by the time the information was aggregated — well, it took forever to go to the credit-rating agencies to share the records, to verify that the borrowers were in good standing and so forth. We take that for granted here — we are able to get a decision in just a few weeks. But the basic infrastructure wasn’t there.
Nationalized banks and rural branches, which tend to not do as good a job as NGOs when it comes to microlending, don’t see the need to spend money to establish infrastructure for NGOs that would allow for improvements in microlending.

Second, the government’s stance could be more helpful. One South Asian bureaucrat asked me why anyone would give microloans to one hundred or two hundred women when chances are only 20 or 30 of them are likely to be entrepreneurs. To his mind, the remaining women were not entrepreneurial and therefore wouldn’t be able to do much with a loan. Now, this business model might not appear to be a very good one at first glance. But a loan might allow borrowers to buy a few things that morning, go to the local bazaar and sell those at a margin and by the evening they would have made certain amount of money for themselves. These women may not be highly skilled entrepreneurs, but for a hundred-rupee ($2) loan you can’t expect a very high level of entrepreneurial skill. The bureaucrats frame the question as if these women need to have a great deal of skill, but a high level of skill is not really required for the system to work.

Q. Along the same lines, many BRAC investors balked at some of the less-than-standard ways that default and current loans were defined, even though the average default rate was extremely low. Why the resistance despite such impressive results?

A. The technology they use is rudimentary—wood stoves, for example—and they live in unhealthy environments and lack access, in many cases, to even primary education. Microfinance lending is properly viewed as part of an overall strategy in which efforts are made to improve primary education, especially for women and children, healthcare and improving domestic tools used for day-to-day activities. Parallel work is being done in these dimensions, and at some point they will reach a critical mass where it may be possible to coordinate those efforts.

Q. Microfinance has been viewed, in its relatively short history, as more or less immune to recessions. Given that the credit crisis underlies the current recession—which is undeniably a global one—might that have a bigger effect on the field than past economic downturns?

A. There will be serious consequences in the sense that soft capital and soft loans that typically go to NGOs and to the poorest of the poor will probably suffer. But while...
Climbing Out of the Aid Trap

Q&A with Glenn Hubbard

Glenn Hubbard discusses how an old plan can become a new solution to help the world’s poorest nations lift themselves out of poverty—by putting business first.

Q. What is the aid trap?
A. The aid trap refers to the problem that most development aid, though well-intentioned, actually hurts the poorest countries because it ultimately prevents the growth of local business sectors. History shows that local business development has been the source of prosperity throughout the world.

Each year, the World Bank publishes a report called Doing Business, which includes a ranking of countries based on the relative difficulty for local citizens to launch and maintain businesses. The report clearly illustrates that countries that receive the most foreign aid have the highest cost of entry for entrepreneurs. The bottom end of the list is composed primarily of nations in Africa.

In the 1960s, by which time most African nations had gained independence, billions of dollars of aid began flowing to Africa. But the agricultural sector are employed by governments and NGOs rather than, as in most societies, businesses. The amount of funding that goes to governments and NGOs dwarfs investment in the business sector.

Africa’s governments are largely content with the current system. Accepting the flow of aid is easy; the large number of people employed in the aid sector depend on it for their livelihoods and aren’t eager to change. Under these conditions, the market can’t operate normally to create wealth, the business sector is marginalized and much of Africa remains poor.

Q. What is your plan for ending poverty in poor nations?
A. The plan that Bill Duggan and I propose is inspired by the one shining success story of official development aid: the Marshall Plan.

The aid system has IMPEDED THE GROWTH of the business sector and helped strangle entrepreneurial efforts.

The original Marshall Plan, proposed in the aftermath of World War II, made loans to European businesses in the form of production inputs: seeds to farmers and machines for factories, for example. The businesses repaid the loans, in cash, to local governments, which in turn invested the repaid funds in rebuilding public and commercial infrastructure, such as ports and roads. At the same time, pro-business policy reforms were implemented. This is a wonderful model in that it creates automatic discipline: investment in infrastructure was dependent on businesses repaying loans. That’s the kind of mechanism we’re advocating.

Will the terms of loans to African countries be different? Yes. Will the infrastructure that the repayment of these loans generates be different? Yes. A great many other details will be different. But the basic mechanism is really quite simple, quite brilliant and hasn’t been tried since the Marshall Plan.

Q. But Africa is very different from post-war Europe. Europe had a well-developed business sector prior to the war, and the Marshall Plan helped to rebuild it. But many African nations don’t have well-established business sectors to begin with. How does this plan account for such different circumstances?
A. When Greece participated in the Marshall Plan, it was strikingly similar to many African countries today. It was small, very poor, war-torn, and there was civil war at the outset. England, though devastated by the war, was comparatively rich with its institutions and economy intact. Despite these differences, Greece and England both benefited from the business and economic development facilitated by the Marshall Plan. Local business is highly adaptable to local circumstance.

“HISTORY SHOWS THAT LOCAL BUSINESS DEVELOPMENT HAS BEEN THE SOURCE OF PROSPERITY THROUGHOUT THE WORLD.”
—Glenn Hubbard
Microfinance, which has made entrepreneurs out of millions of individuals in the world’s poorest countries, is an example of this. Muhammad Yunus, who developed the concept of microfinance while a professor of economics at Chittagong University in Bangladesh and who won the Nobel Peace Prize in 2006, understood the inherent adaptability of local business sectors. When the Grameen Bank lends money, it doesn’t dictate how borrowers should run their businesses, or how or with whom they must trade. The bank requires only that loans be repaid. Like the Grameen Bank, our plan would not dictate the terms of business.

Q. Why isn’t something like microfinance enough?

A. Microfinance can be a catalyst for entrepreneurship up to a certain stage of business development, but the businesses launched through microfinance need to develop into full-fledged small businesses if they are to promote greater economic growth. Small and medium-sized businesses are the source of growth in all countries. Eighty percent of China’s employment, for example, is in small business—not in microfinance.

The barriers to growing past micro-entrepreneurship are formidable. Starting a formally-recognized business can require months of waiting, and paying enormous fees—including bribes—as the Doing Business rankings show. An example we use in the book is Mozambique, where starting a business requires forms from 12 government agencies; you also have to pay bribes to each of the 12 government employees who stamp your documents. When you have 12 stamps, you can—at last—run your business without fear of being shut down. Similar hurdles in other countries mean that micro-entrepreneurs have a very difficult time becoming a political or economic force strong enough to challenge the status quo.

The bright spot is that micro-lenders are increasingly expanding their loan programs to serve not only individuals, but also established small and medium-sized businesses. Our proposal includes provisions for supporting existing small and medium-sized businesses through microfinance institutions.

Q. How do you define success for this plan?

A. Success for each country will vary, but the key indicator will be seeing a substantial percentage of the population move out of poverty. For the smallest poor countries, that might require 50 years of sustained investment in the development of their business sectors. Remember that it took Europe about a century to move from feudalism to private business. India and China, with so many natural resources, have moved relatively quickly over the last few decades. To move from poverty to prosperity in 50 years would be quite good.

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William Duggan is senior lecturer in business in the Management Division at Columbia Business School.

Glenn Hubbard is dean of Columbia Business School and the Russell L. Carson Professor of Finance and Economics.
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