Is There Value in the Emerging World of Social Commerce?

Businesses can profit by getting connected to competitors.

In recent years, social commerce—business models that combine social networking with e-commerce—has been an emerging trend in the online world. Such online commerce sites as Amazon and eBay are adding some social networking features, and there has been much speculation about whether social networking giant Facebook could somehow generate revenue from its 100 million active members and become enormously profitable. Other start-up companies, such as zlio.com, are creating social commerce marketplaces from scratch. Social commerce is perhaps the logical next step forward from social shopping, which allows shoppers to post reviews and recommendations. Social commerce sites are networks of sellers, not buyers, connecting individual stores, much like a suburban shopping mall.

Professor Olivier Toubia, with doctoral student Andrew Stephen, analyzed this new business model to find out whether it benefits sellers as well as owners of networks. The premise of social commerce sites is, to some degree, counterintuitive: a shop that connects customers to other shops risks driving business to its competitors.

The researchers obtained data from a sprawling social commerce site that has platforms in Britain, France, Germany and the United States and hosts more than 300,000 shops. In 2006, this site began allowing shops on its platforms to connect to one another, in a similar manner to friends on Facebook. Before 2006, the site did not have a social networking feature; although it had thousands of shops as members, the shops were not linked. By comparing data from before and after the social networking feature was added, the researchers could measure the impact of social networking on revenue, for both individual shops and the owners of the network.

The researchers found that linking sellers increased profits for the marketplace as a whole, but the benefit was very small. One reason for this, the researchers determined, was that some shops on the network had links directed to them but did not link in turn to other shops. (The network did not require reciprocating links between shops.) “A lot of the value of the network is cancelled by these dead ends, or free riders,” Toubia says. “Dead ends limit the browsability of the network, and a frustrated consumer who reaches one might just leave the marketplace.” As its network grows, he says, a social commerce site should impose rules to eliminate dead ends.

Next, the researchers analyzed the network at the shop level. They looked at many factors, including how many links are directed to a shop; the extent of clustering, or interconnected links, among a shop’s neighbors; and how easy it is to reach other social commerce sites continued on page 2
shops from a shop (the equivalent, in social networking terms, of the degree of separation between friends).

The researchers found that having a relatively large number of links directed to a shop benefits that shop. They also found, more surprisingly, that linking to other shops has a net positive effect, even though this may increase competition. On average, a shop that links to another shop has a 67 percent chance of receiving a reciprocal link, and the benefit of that reciprocal link outweighs the negative impact of the initial link. “It makes sense to link to other shops, even though you are sending customers away,” Toubia says. “It helps more than hurts, because in most social networks people link back.”

In contrast, the researchers determined that being part of a cluster—or neighborhood, in network parlance—has a negative effect. Suppose a shop is in a neighborhood of 10 stores, all of which are linked to one another. The only customers who are likely to find the shop are those who stumble upon the neighborhood. Rather than become parts of closely linked neighborhoods, the researchers found, shops should cultivate links from a variety of other shops spread as far as possible across the network.

The researchers also found that having fewer degrees of separation between a shop and other locations has a negative effect on the shop because it is easier for customers to leave. At the same time, it benefits shops to be easily reachable from other shops in the network.

Overall, the researchers found that social commerce makes sense as a business model. Stores benefit from connecting to one another, and customers benefit because it is easier to browse among stores. However, given that shops benefit most when they are relatively accessible from other shops but limit accessibility to other sellers, Toubia warns that not all social networking sites are suited for commerce.

“On traditional social networking sites, people tend to reciprocate links and tend to cluster,” he says. While reciprocating links increases customer traffic, clustering tends to hurt a seller.

Given these competing factors, sites such as Facebook should proceed cautiously when experimenting with social commerce, Toubia says. “Some of the natural forces that drive social networks can actually work against them if their owners try to turn the community into a network of sellers.”

Read More

Olivier Toubia is the David W. Zalaznick Associate Professor of Business in the Marketing Division at Columbia Business School.

Achieving Synergies in a Merger
How corporations can balance tradeoffs between standardization and local adaptation.

The management of every corporation—particularly one that is facing a merger—struggles with how to organize its operations to maximize profits. Most large corporations are divided into business units that focus on specific products or geographic regions, while some functions are centralized at the corporate level. General Electric, for example, handles sourcing as a global activity and leaves sales, distribution and manufacturing to product business units. A nd at Procter & Gamble, product development, accounting and finance are centralized, while sales, distribution, manufacturing and procurement are managed by regional business units.

These hybrid structures always involve tradeoffs. Centralizing activities can achieve cost savings through standardization, but business-unit managers typically want to customize processes in a way that increases profits in their division. A nd because corporate managers and business-unit managers have different incentives and motivations, coordinated decision making and planning can be difficult.

Professor Wouter Dessein, working with Luis Garicano and Robert Gertner of the University of Chicago, analyzed how to balance these competing interests in corporations. Their findings help predict the likely success of a merger between two firms, given the firms’ organizational structures.

Consider two large car companies that are undertaking a merger. If the new management allows all the functions of the original companies to remain independent, nothing is gained from the merger. To take advantage of synergies, management may decide to centralize a function, such as product development. The new corporate manager of product development would be responsible for cost savings in the production of new cars.

This might be a good choice for the bottom line, but the corporate manager may impose excessive standardization, which in turn can reduce revenues. To avoid a decline in sales, management may experiment with different ways of allocating...
authority, perhaps requiring the corporate manager to get approval for all his or her decisions from the business-unit managers (which can effectively bring centralized management to a standstill).

The researchers found that the best way to handle these dilemmas is to change the corporate manager’s incentives to cut costs. “If you want corporate managers to make good decisions about standardization without going overboard, you need to weaken their incentives,” Dessein says. “You need to make them care about the whole organization.”

Typically, firms benefit by giving strong incentives to managers. But if the corporate managers have very strong incentives to cut costs, Dessein explains, they will not consider the needs of the business managers. But lowering incentives has its own risks. “In the case of a stand-alone firm, would you give corporate managers a flat wage?” he says. “It depends on how effective variable pay is for managers in the company.”

In corporations that emphasize variable pay as a tool for motivation, Dessein says, both corporate and business-unit managers may be held strictly accountable for the performance of their units, but business-unit managers should then be given more authority. In this case, the corporate managers will still seek excessive standardization, but the business-unit managers will be able to block any standardization that is not to their advantage. “With this type of structure," Dessein says, “you preserve high-powered incentives, but you will get only win-win synergies, because all the business-unit managers will have veto power.”

However, this structure runs the risk of excessive decentralization, making it difficult to manage the corporation efficiently. Therefore, the researchers propose that companies centralize those activities in which incentives are less important, such as R&D and human resources, and benefit from a standardized approach that can lead to cost savings. “For these types of functions, the incentives are naturally diffuse," Dessein says. “If you’re in charge of product development for a whole firm with hundreds of brands, there are limits to what you can do. If you care about the profitability of each and every product, you don’t care much about any single product in particular.”

Because the goal of mergers is often cost savings, the researchers predict that merging companies whose original structures are based on strong incentives are more likely to fail. “It’s far more difficult to realize the synergies in that case,” Dessein says. The most challenging mergers are those in which the synergies to be obtained come from many small, distinct decisions. Such decisions need to be made on a case by case basis by corporate managers whose incentive structure is such that they may impose excessive standardization. However, if all the synergies are likely to be achieved from just a few big decisions at the merger’s outset, combining the companies can be successful.

“Every firm faces these questions, but with mergers, the challenges are more visible,” Dessein says. “Merging companies often have the idea of saving costs by standardization. But they ignore the ‘organizational discount’ that should be applied in valuing the merger: the changes in the incentive structure that are required to make it work.”

Read the Research

Wouter Dessein is the Eli Ginzberg Professor of Finance and Economics at Columbia Business School.
THE IDEA
Buyers and suppliers can both gain from a procurement strategy that uses an auction to eliminate guesswork.

THE RESEARCH
In search of ever-more competitive prices, buyers must frequently seek out new suppliers to secure products or raw materials. When buyers have the option of purchasing goods from multiple suppliers, however, they must navigate the market without the benefit of knowing suppliers’ production costs, which suppliers don’t reveal. Buyers, therefore, are limited in their ability to negotiate the lowest price.

On the other end of such transactions, suppliers face fierce competition for contracts with buyers and must often pay controversial slotting allowances. Slotting allowances are widespread and are most notably used in grocery stores to guarantee that a new product is placed on shelves or that an older product is given a special promotion. Such allowances can divide the risk associated with introducing a new product between the manufacturer and the retailer. But because slotting allowances are dictated by buyers, who can set fees as high as they want, this practice can give an unfair advantage to established suppliers and discourage new, up-and-coming suppliers.

Professor Fangruo Chen developed a mathematical model to devise an optimal procurement strategy that allows buyers and suppliers to reap the maximum benefits by using an auctioned contract.

Chen’s strategy requires a buyer soliciting a supplier to present a contract that specifies the minimum and maximum quantity of a product, as well as how much they are willing to pay for different quantities. The contract is then put up for auction, and the supplier who bids the highest slotting allowance wins. (The buyer remains unaware of the supplier’s production costs, but the supplier, in order to maximize its profits, must consider these costs when bidding.)

Also, though buyers traditionally manage inventory, Chen’s contract stipulates that the supplier manages inventory. This benefits the supplier, who decides how much to manufacture and deliver and can take advantage of economies of scale to produce the most cost-effective quantity.

Buyers must navigate the market without the benefit of knowing suppliers’ production costs.

PRACTICAL APPLICATIONS

Buyers, retailers
You can use this strategy to negotiate the lowest price for a product or raw material, as well as to secure the highest slotting allowance from a supplier. This method also minimizes the controversy associated with slotting allowances, because all suppliers have the opportunity to bid, regardless of your preset minimum fee.

Suppliers, manufacturers
You can use this strategy to maximize profits based on what a retailer is willing to pay for different quantities of goods. This strategy puts you in charge of managing inventory by allowing you to determine the most cost-effective quantity of goods to produce and deliver.

Read More

Fangruo Chen is the Ira Rennert Professor of Business in the Decision, Risk and Operations Division at Columbia Business School.
The Instinctive Offer
Negotiators who rely on their feelings often come out ahead.

Conventional wisdom dictates that the best way to approach an important decision is to do so analytically — by, for example, considering potential outcomes and listing the pros and cons of each possible course of action. Yet research has shown that decisions, both personal and professional, are often made instinctively and subjectively. Rather than evaluating the potential outcomes of various options, people often rely on how different options make them feel.

In the world of business, decisions are frequently reached through negotiations that involve high financial and strategic stakes. Negotiations can be complex: All parties are usually inclined to come away from the table having advanced their positions. At the same time, offers are rejected and accepted for a variety of underlying reasons — for example, pride, the drive to win, or preserving a relationship may trump other factors.

Should parties to a negotiation embrace a calculating, analytical strategy, or should they rely instead on their instincts and feelings? To examine how the reliance on instincts and feelings influences negotiations, Professor Michel Tuan Pham, working with doctoral candidate Andrew Stephen, used a classic negotiation game called the ultimatum game.

In this game, one person is assigned the role of proposer and must divide a given amount of cash with a second person, the responder. If the responder accepts the offer without negotiating, both players can keep the money. If the responder rejects the offer, both players walk away empty-handed. The game simulates real-life negotiations in which both parties need something from each other and have an incentive to reach a deal.

In a series of experiments, the subjects were divided into two groups and subtly encouraged or discouraged to rely on their feelings using a novel research technique known as the trust-in-feelings manipulation, which was developed in collaboration with Tamar Avnet (PhD ’05) of Yeshiva University. One group was asked to think of two instances in which they trusted their emotions when making a decision and the outcome was favorable. Because it is relatively easy for most people to think of a few such instances, this group was likely to trust their feelings in decisions. The other group was asked to recall 10 such instances. Because it is more difficult to think of many such instances, this group was likely to distrust their emotions in decisions.

The subjects were then asked to play the ultimatum game, taking the role of proposer. They were led to believe that they were playing against a real online responder, although they were in fact playing against a preprogrammed computer.

“The results were intriguing,” Pham says. “The participants who were encouraged to trust their feelings offered somewhat less money than those who did not trust their feelings, but their offer still fell in a range that was likely to be accepted. Those who trusted their feelings apparently made their offer based on whether the amount ‘felt right’ given the situation rather than on the probability that it would be accepted or rejected.”

Relying on such emotional instincts may simplify the negotiation process. “When the participants were primed to trust their feelings, they saw the negotiation in simpler terms, rather than as a complex, strategic task,” Pham explains.

“Interestingly, negotiators who were guided by their emotions did not fare worse than the others financially,” Pham says. “They ended up with at least as much money, and often more, than their calculating counterparts, suggesting that emotional decision making may be not only simpler but also more lucrative.”

Read More

Michel Tuan Pham is the Kravis Professor of Business in the Marketing Division at Columbia Business School.
Lenders Enter the Limelight with Caution
Transparency in credit markets may have unintended consequences.

What is the effect of making credit information public when borrowers find themselves close to financial distress? A creditor’s decision to continue to finance a firm depends on both uncertain borrower creditworthiness and the expected decisions of other lenders. A creditor has less incentive to continue financing if it believes that other creditors are about to withhold financing. This occurs because the lack of credit from one creditor can potentially disrupt the operations of the firm, making it less profitable for other lenders to extend credit. This creates an incentive for lenders to coordinate— that is, to lend only to firms that lenders believe will not have any problem obtaining funds from other lenders.

Since lenders have an incentive to coordinate their financing choices, these choices become highly sensitive to public news, because it helps forecast actions other lenders are likely to take. As a result, if bad news is released publicly, it can make firms more vulnerable to a creditor run, in which each lender withholds financing from a firm because it believes other banks will do the same. A firm can be forced into financial distress, even though the fundamentals of the business would still profitable if it could obtain enough short-term credit. Releasing public information can have a similar effect in triggering bank runs and currency attacks, because one investor’s return is affected by the investment decisions of others.

Professors Andrew Hertzberg and Daniel Paravisini, working with José María Liberti of DePaul University, measured the effect of making credit information publicly available by studying the expansion of a public credit registry in Argentina. Public credit registries are government-managed databases of credit information on borrowers. Registries exist in 71 countries and often mandate that information about borrowers be shared across banks.

In April 1998, Argentina’s central bank, which receives credit ratings from all the country’s lenders, announced that it would make all credit reports in its registry public; until then, the central bank had made credit information public only for borrowers whose outstanding credit liability totaled $200,000 or more.

Hertzberg and Paravisini compared the lending practices of banks before and after the credit-registry threshold was lifted to learn what, if any, effect the change had on banks’ use of information. The researchers studied small to medium-size firms, limiting their study to those that borrowed between $175,000 and $225,000.

They found that the newly public credit reports affected the relationship between the lenders who gave poor ratings and the borrowers who received them. Before the credit registry was public, a lender would proceed more cautiously with a firm that had received a bad rating, but would not terminate its lending. A firm the credit registry was made public, anticipating that other banks would be less likely to extend credit to firms it had rated poorly, lenders decreased their lending to borrowers with low ratings.

In the month following the registry expansion, lenders who had reported poor credit ratings reduced their lending, on average, by 15 percentage points. In their preemptive move, lenders refused to provide liquidity, which serves as an emergency loan for a firm that may be short of cash. As a consequence, default by their borrowers increased by 13 percentage points.

“We found a disruption in liquidity injections,” Paravisini says, “which ran dry after the registry expansion is announced.” On average, firms whose credit information was shared through the registry experienced a significant decline in their total debt.

“Though we’re seeing increasingly volatile lending decisions,” Paravisini says, “there are positive aspects to forcing banks to share information.” For example, a registry allows lenders to know if a firm is borrowing elsewhere or if the same collateral has already been pledged to another lender. In most developed countries, including the United States, sharing credit information is not mandatory. However, the same effect can occur with other public sources of credit information, such as bond ratings and analyst forecasts.

“Because of the current financial crisis, government intervention in financial-market regulation is going to be a key topic,” Paravisini says. “The potential effects of making credit ratings public — positive and negative — are an important force to keep in mind.”

Read More

Andrew Hertzberg and Daniel Paravisini are assistant professors of finance and economics at Columbia Business School.
Supply chain managers work in a constant state of uncertainty: demand uncertainty, or how much a firm’s customers are going to ask for, and supply uncertainty, or how many components or raw materials a firm’s suppliers can provide at a given point in the future.

While demand uncertainty is one part of the puzzle, understanding supply uncertainty is critical for managing production efficiently. Firms are subject to a variety of factors that can leave them unable to meet demand from customers: a supplier might have promised some of its capacity to another firm, or might need to temporarily slow or stop delivery to maintain its manufacturing equipment. Fluctuations in supply can paralyze a firm, which may find itself unable to produce a key product or to plan for future production.

Such fluctuations may sometimes be known in advance to the supplier but not to the firm. Some suppliers have agreements with downstream firms to share forecast information about their capacity to deliver, and firms often welcome such collaboration. But firms don’t typically have an easy way to factor forecast information into decision making or to calculate how much better off they are with the information.

Professor Alp Muharremoglu and doctoral student Mehmet Sekip Altug examined a supply chain setting with capacity forecast sharing and devised a simple formula that can be used by managers to incorporate the forecast information into their replenishment decisions. They also analyzed supply-collaboration scenarios to determine when advance supply information is most useful. The researchers found that, overall, such supply forecasts are most valuable to a firm when the ratio of the firm’s average demand to the supplier’s average capacity is moderate.

**PRACTICAL APPLICATIONS**

**Supply chain managers**
You can use this formula to incorporate advance supply information into replenishment decisions. For example, if the forecast indicates a low level of capacity availability next month, the formula indicates how much you should increase the current month’s order to plan for the upcoming shortage.

**IT managers**
You can use this formula to determine how cost-effective it would be for your firm to purchase, install and operate information technology to receive and to use advance supply information.

**Read More**

Alp Muharremoglu is assistant professor of decision, risk and operations at Columbia Business School.
Global Customers Seek Global Firms

Q&A with Noel Capon

Noel Capon talks about how firms can retain and grow their most valued customers by shifting from country-based account management to global account management.

Q. Why is global account management so critical now?
A. Big companies that operate around the world have realized that a country-by-country approach may not be the most effective or efficient way to manage their procurement. Increasingly, they are developing global procurement organizations and mandating that goods be purchased through that channel; often, they’ll use separate structures for local procurement.

Many organizations are outsourcing more and more of their activities. Effectively, they place operations into two categories: what they buy through procurement versus what they continue to do internally. The balance is shifting toward procurement as organizations outsource operations, such as data centers and travel arrangements. This makes procurement more important— saving a few percent on procurement has a major impact on the bottom line.

It’s quite a large shift. Imagine if 15 or 20 years ago the boss said to a manager, “Your next position is going to be in purchasing.” That was often the kiss of death in terms of career advancement. If today the boss says to a manager, “You’re going to procurement” — which is purchasing rebranded — you’re a high flyer.

Q. What did customer management look like before global account management?
A. Most multinational firms developed by sending someone abroad to manage their activities in a single country — a country manager who was responsible for revenues and profits in that country. The marketing and sales organizations would typically do their best for customers operating in that country. The customer — the buying company — might get different product variations, because, for example, Argentineans wanted one feature, while the Australians wanted a different feature. For both buyers and sellers, these were multinational operations, not global operations.

Today, on the procurement side, companies are recognizing that it doesn’t make sense for them to do all of their buying country by country, for two reasons: First, the price they pay for a given item might vary dramatically by geography. Their supplier might charge more in Argentina than it charges in Australia, or vice versa. Second, there is a lot of product variety.

IBM might produce one set of computers for customers in Argentina and a slightly different version of the same computers for customers in Australia. Buying companies increasingly want to know why they can’t get one price schedule across the world. They also believe that standardizing the different varieties they are buying in different countries should help reduce prices. But when they take this question to the selling company, their supplier, there is no one to talk to — the selling is organized by geography.

In short, multinational firms assign country managers to handle many customers in a single country; global firms assign global account managers to handle a single customer’s needs all over the world.

Q. So, you make a distinction between multinational and global operations.
A. Globalization means two different things. There have been multinational companies for decades, companies that realized there were opportunities in foreign markets. Both European and U.S. firms have done a great job of moving out of their domestic markets into many countries in the Americas, Europe and Asia, for example. Now Asian firms are doing the same.

We tend to talk about that as going global, but it’s more likely that such firms are operating with a multinational — that is, country-by-country — perspective. A global company makes its decisions — and in particular, its procurement decisions — around the world as a whole, rather than country by country.

Q. What risks are involved in developing a global account management program?
A. The strongest internal barriers are found in multinational firms, typically divided into four or five geographic regions, and where individual country managers are measured and rewarded on how well they do in their countries.

What happens when a key customer wants to buy globally? Suppose IBM is selling products and services to Citibank, and Citibank has operations in Argentina. IBM has a global account manager to manage IBM’s Citibank business all over the world, and Citibank says that its Argentinean operation is very important. The IBM country manager in Argentina has Citibank as one of his customers, but he also has local South American customers. Perhaps Citibank is not a big deal for him — his local customers are more important to him — and he might not want to put a lot of effort into Citibank, because he’s got scarce resources and he’s measured and paid on how well he does in Argentina.

That’s the core dilemma. If a firm’s organizational structure and reward systems are set up for multinational business, global account management has to cut across that.
Q. How can a business make the transition to global account management less challenging?

A. Firms can reorganize to modify the role of countries and country managers and put more emphasis behind the global account manager. The other way is to continue with the multinational organizational structure but work at the margin to make the organization operate more globally. Taking the previous example, if the CEO is constantly saying that big global customers are critical to the company, he has to tell that country manager for Argentina, “I know we pay you on what you do overall in Argentina, but I really want you, no matter what, to make these global customers a key priority. We will make sure you’re rewarded for how well we do with those customers.”

It takes a lot of resources. All managers want resources, so if you are putting resources into global account management, you’re asking, “Is this the right place, or should I be putting resources into R&D or another area?”

Firms also have to constrain the behavior of geographic-area managers and country managers. The global account manager has to figure out how to make that country manager in Argentina put more effort towards the global customer than he or she may want to because of commitments to local customers. Maximizing performance in Argentina is not the same as maximizing performance at Citibank around the world. It takes a lot of leadership from the top to say, “Our global customers are really important, and we are going to support them wherever they want to do business with us.”

A firm should not launch a large global account management program from scratch. If it starts off with 50 customers at the same time, the program will fail. I advise doing it slowly: say, a half dozen customers first. Figure it out, get it right and then add new customers incrementally. It’s important to understand that it takes a long time for a company to create a system that really works.

Q. The global account management approach is still taking hold. As that happens, what can local markets take from it?

A. A lot of companies have adopted the key/strategic account management approach, which recognizes the 80/20 rule — 80 percent of a firm’s business comes from 20 percent of its customers. The firm has got to be somewhat more concerned about that 20 percent than with the average customer. In a sense, the global account management approach ratchets that up a notch.

Q. Does that mean that strategic account management is good preparation for global account management?

A. Yes, but you have to be careful. A very good domestic account manager may not be a good global account manager. Several years ago a Fortune 50 firm had a good domestic strategic account management process and realized it had to go global. The firm made its national account managers global account managers. But some of them had never had passports!

It can be difficult to find good global account managers. It’s a very difficult job to manage one customer around the world in different time zones and in different cultures — it’s much more complex than managing a customer in a single country or even a single region. Until a year or so ago, there was no educational opportunity to develop global account managers. That’s why Executive Education here at Columbia Business School worked with the University of St. Gallen in Switzerland to create a world-class four-week Global Account Manager Certificate Program to fill that void.

Managing a global customer is like running a business; your customer is a core asset and requires a lot of investment. Our IBM global account manager for Citibank is managing a business whose revenues could total several hundred million dollars a year. That’s why it’s critical to understand that the global account manager job is not just a sales job. It’s a long-term, strategic, business-management job.

Read More

Noel Capon is the R. C. Kopf Professor of International Marketing at Columbia Business School.
Guiding Monetary Policy with Responsive Autonomy
Q&A with Frederic Mishkin

Assessing the work of the Federal Reserve, Frederic Mishkin contends that communication and transparency must counterbalance the necessary independence of a strong central bank.

Q. In your book Monetary Policy Strategy, you establish a scorecard for the Federal Reserve and rate its strengths and weaknesses. How do you score the Fed on its response to the financial crisis?
A. A lot of criticism has been leveled at the Fed, yet the bank has been extremely aggressive in its response to the financial crisis in what are arguably the two most critical ways: in monetary policy easing and, to an even greater extent, in injecting liquidity into the system in many forms, some of them very creative.

Central banks have not always understood the necessity of taking these kinds of strong actions. The Bank of Japan was not on top of easing and liquidity provision during Japan’s episode in the late 1980s. I think the Fed has pursued a much more aggressive approach because the academic literature makes clear that standing back in this kind of crisis is a prescription for disaster. That’s what happened during the Great Depression.

A foremost aspect of a central bank’s role is to consider and mitigate financial crises. That has been an undeniably strong element in the Fed’s past policymaking.

Q. What are some of the other policy issues a central bank must consider when determining how to respond to this—or any—financial crisis?
A. There is a whole set of policy issues, but to illustrate how complex they can be, consider the question of asset-price bubbles.

While it is important to pay more attention to bubbles than in the past, because they affect the overall economy, I argue that central banks should not be involved in using monetary policy to prick these bubbles.

First, asset-price bubbles can be hard to identify. If a central bank tightens monetary policy to restrain a misidentified bubble, it risks weakening economic growth. Even if asset-price bubbles were identifiable, the effect of interest rates on bubbles is extremely uncertain. Some theoretical models suggest that raising interest rates can diminish the acceleration of asset prices, but higher interest rates may not be very effective in defusing bubbles, because market participants expect excessively high rates of return for buying bubble-driven assets. Other research and history suggest that raising interest rates may cause a bubble to burst more severely, damaging the economy further.

Also, there are many asset prices, but a bubble may be present in only some assets. In such a case, monetary policy can be a very indelicate instrument and would probably impact asset prices broadly. It’s not possible to target individual asset bubbles.

As I discussed in my book, central banks are more likely to encourage better economic outcomes by responding to the outlook for inflation and aggregate demand than by pricking bubbles. I retain that position, but there is an additional related issue that I did not discuss in the book. We should not ignore the possibility of bubbles altogether; in a speech I gave as a governor of the Fed back in May, I argue that the right way to cope with potential asset-price bubbles is through macro prudential supervision—regulatory and supervisory policy—rather than through monetary policy.

Q. In recent years, many central banks have adopted inflation targeting, a practice you’ve strongly advocated that the Fed adopt.
A. Yes, and there is an even stronger need to have a numerical inflation goal on the table given the financial crisis. Setting an inflation goal can better help to anchor the inflation expectations of households and businesses, which helps them make economic decisions in the immediate and moderate-term future. In turn, that would allow the Fed to be more aggressive during shocks, because there is less fear that it will blow out inflation expectations.

Also, we are in a very deflationary shock right now. In terms of price stability, it’s important to keep inflation from rising, but it’s just as important to mitigate deflation by having a commitment to a positive inflation target.

Q. In another book, The Next Great Globalization, you addressed the greater risks that emerging markets face when confronting financial crises. In the past, such crises almost always occurred as a result of regional or homegrown economic strains. Are risks for these markets greater or lesser now that we are looking at a global crisis, and what policy action is called for?
A. Whenever a nation is subject to an external shock, its vulnerabilities are much greater if it has not pursued certain reforms. Many emerging markets have moved in the direction I suggested in that book, which has made them less vulnerable to the worst effects of the shocks we are all experiencing now. Although emerging markets are getting hit right now, they would be far worse off if they had fixed exchange rates and had a lot of debt denominated in foreign currencies.

Many countries did not learn these lessons, including some advanced and semi-advanced economies. Iceland had a huge amount of dollar-denominated currency and

INTERFERING WITH THE INDEPENDENCE OF A CENTRAL BANK CAN PRODUCE EXTREMELY BAD OUTCOMES.

—Frederic Mishkin
dollar-denominated debt. The same is true of many of the Eastern European ex-Soviet-bloc countries, like Hungary and Estonia.

**Q.** Your scorecard rates the Fed as mixed on transparency and communication, and you say these areas need some work. One of your recommendations is that the Fed move in the direction of establishing an explicit, numerical inflation goal.

**A.** Communication and transparency have improved a lot under Chairman Bernanke, but the Fed has not moved nearly far enough. I’d like to see the Fed make longer projections, reach a consensus on a specific numerical value for the desired level of inflation rate and change the consensus value only for good scientific reasons.

The legal concept stare decisis can be useful in thinking about how the Fed should establish and communicate its targets. Stare decisis—literally, “to stand by things decided”—dictates that when the Supreme Court makes a decision, the reasoning behind that decision serves as precedent that guides all subsequent decisions, except when the court finds compelling reasons to modify or overturn that earlier decision.

My recommendation for a communication strategy is that the Fed work in a roughly similar fashion: because the way the Fed arrives at its consensus value for the desired level of the inflation rate would be very transparent, the Fed would not make changes, except for sound economic reasons. The Fed would be accountable to explain any change to the inflation goal, and it would therefore provide a firm anchor for long-run inflation expectations. The Fed would still retain enough flexibility to ensure that monetary policy is consistent with exercising its most important mandates—encouraging price stability and maximum sustainable employment.

**Q.** The Fed has become quite independent in recent years, which is consistent with international trends and with your position that central banks should have more independence, particularly in democratic nations. Do you foresee any change for the Fed as a result of the crisis or the new presidential administration?

**A.** I do worry about this issue. There is always some discomfort in having a powerful and independent central bank, and the recent criticism directed at the Fed may result in calls to rein in its independence. We don’t yet know whether the Congress will try to rein in the Fed’s independence, given the prominent role the central bank has had to take during the crisis.

Interfering with the independence of a central bank can produce extremely bad outcomes. One reason I argue so strenuously for transparency is that it makes a strong central bank more conducive to operating with accountability in a democratic society. The best path is to allow the Fed to maintain its independence, while requiring increased accountability by encouraging transparency and improving how it communicates with Congress and to the public.

Read More

Frederic S. Mishkin is the Alfred Lerner Professor of Banking and Financial Institutions at Columbia Business School. He is a research associate of the National Bureau of Economic Research, and from September 2006 until he rejoined the School in August 2008, he was a member of the Board of Governors of the Federal Reserve System.
Columbia ideas at work
CONNECTING RESEARCH TO THE PRACTICE OF BUSINESS

IN THIS ISSUE . . .

Frederic Mishkin weighs in on the Fed's response to the financial crisis, Andrew Hertzberg and Daniel Paravisini measure the effect on lenders of making credit registries public, and Wouter Dessein predicts the likely success of mergers. Olivier Toubia shows why getting closer to other online competitors can help, rather than hurt, in social commerce. Noel Capon explains why global account management isn't just about doing worldwide business as usual. Alp Muharremoglu devises a formula that allows manufacturers to capitalize on forecast supply information, and Fangruo Chen creates a procurement strategy that uses an auction to eliminate guesswork for both buyers and suppliers.

To read more about the ideas covered in this issue—and to explore research findings on other business topics—visit the Columbia Ideas at Work Web site:

www.gsb.columbia.edu/ideas