



WINTER 2006: **EMERGING MARKETS**

Findings from Faculty Research at Columbia Business School

Emerging Markets

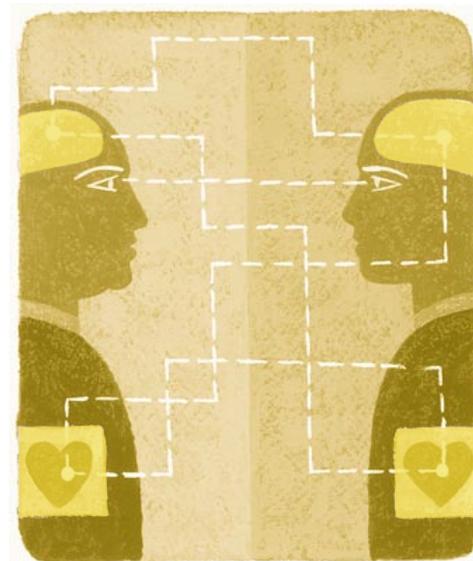
In the past 25 years, developing countries have become increasingly active participants in global markets for goods and capital. International trade is transforming developing countries—for better or for worse—and these countries are, in turn, transforming the world economy and the lives of consumers and workers in advanced countries.

It has never been more important for policymakers, business practitioners and investors to understand the complexities of doing business in emerging markets.

This newsletter highlights innovative research findings on many aspects of this topic, including trade policy, capital flows, bank regulation,

entrepreneurship, corruption, cross-cultural business relationships and bilingual branding.

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Trust and Reciprocity in American and Chinese Business Networks

Why do business relationships take longer to establish in China than in the United States? New research explores key differences between the American and Chinese approaches to building networks.

Are your relationships with your coworkers qualitatively different from your relationships with your friends? Are you more inclined to do a favor for a prospective client than for an acquaintance who has little to offer in return? If you are American, the answer to both questions is probably yes. If you are Chinese, however, it may be natural for you to seek emotional support from work colleagues or to go out of your way

Trust continued on page 2

In This Issue

Trust and Reciprocity in American and Chinese Business Networks	1
Thinking Small: Entrepreneurship in India <i>Q&A with Amar Bhidé</i>	3
Gauging Corruption's Impact	5
Making Globalization Fair <i>Q&A with Joseph Stiglitz</i>	6
Global Capital Flows and Financial Crises <i>Q&A with Charles Calomiris</i>	7
Small Firms' Access to Credit in Emerging Markets	9
Research Brief: Bilingual Branding	11

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to help someone who is not in a position to directly return the favor.

While Americans typically maintain some separation between their personal and professional lives, Chinese tend to establish almost family-like bonds with their business associates. Professor **Michael Morris**, who has conducted comparative studies of business relationships in different cultures since the 1990s, suggests that this is one reason that business relationships take longer to establish in China. “In China, if you’re going to do business with someone you start by forging a personal, affective bond—you exchange gifts, you have a series of meals together, you may be invited to meet their family. The personal bond paves the way toward a working relationship.”

Foreigners doing business in China

Chinese managers have extensive overlap between their personal and professional networks: the people they trust with their heads tend to be the same people they trust with their hearts.

learn two words that describe important aspects of Chinese business culture: *guanxi*, which means “connections,” and *renqing*, which means “favor.” “Though *guanxi* translates literally as ‘connections,’ expatriates in China quickly figure out that you don’t build *guanxi* through the same kinds of networking that you could use to develop your connections in New York,” says Morris.

But how exactly do Chinese tendencies in networking and favor exchange differ from those in the West? In a series of studies, Morris, Professor **Paul Ingram** and doctoral student Roy Chua have

used social network surveys to compare and contrast the Chinese concepts of *guanxi* and *renqing* with the American concepts of networking and reciprocity.

The researchers surveyed Executive MBA students in China and New York, asking them detailed questions about their networks. The executives identified each person in their network as a source of economic resources, emotional support or crucial information. They also indicated the degree to which they felt two kinds of trust— affective and cognitive—toward the other person. This distinction between trust from the heart and from the head turned out to be the key to understanding the difference between Chinese and American networks.

“Both types of trust involve a willingness to make oneself vulnerable to the other person,” says Morris, “yet cognitive trust is depending on them based

on a judgment of their competence, whereas affective trust is confiding in them based on the feelings of liking them. Our hypothesis essentially was that these two forms of trust would be more intertwined for Chinese managers than for Western

managers.”

This hypothesis is consistent with Ingram’s experiences working with executives in both places. “Chinese executives accept that personal feelings co-mingle with business judgments,” he says. “Westerners are more likely to struggle to separate these, to keep business judgments impersonal.”

The studies’ findings confirmed that Chinese managers have extensive overlap between their personal and professional networks: the people they trust with their heads tend to be the same people they trust with their hearts. By contrast, American managers have



a division of labor in their relationships: they tend to have cognitive trust in a circle of business associates and affective trust in a separate circle of friends and family members.

One study measured executives’ willingness to do time-consuming favors for each person in their network. The researchers found that the Americans were much more likely to do favors for people who were in a position to be of significant assistance to them. The Chinese executives, on the other hand, were willing to extend themselves to help people who had little to offer in return. The Chinese responses suggest a system of indirect reciprocity that is consistent with the concept of *renqing*.

“What *renqing* literally translates to is ‘favor,’” Morris says, “and in the way it’s used in Chinese, it’s very closely related with another term, *mianzi*, which means ‘face.’ The idea is that if you do favors for people in your community, within the circle of people that you interact with, it increases your face—the esteem that the community collectively ascribes to you. This system of face functions much like a credit rating. If you have helped a lot of the others, you’ll be seen as high in face, and this makes it very hard for people to say no when you do ask for something.” Chinese executives did show a direct reciprocity pattern in their relationships

Trust continued on page 3

to non-Chinese expatriates, whom they seemed to view as being outside of the indirect reciprocity system.

China's collectivist history provides a partial explanation for the prevalence of *guanxi* and *renqing* in Chinese business culture. The lack of a strong legal system is another important factor. "Anywhere in the world where people have to do business without legal institutions, you'll see some form of building very close affective relationships with people that you have to trust," says Morris.

Read More

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Michael Morris and Paul Ingram are professors of management at Columbia Business School.

Thinking Small: Entrepreneurship in India

Q & A with Amar Bhidé

Despite all the fuss about offshoring to Bangalore, Amar Bhidé claims it can't transform India's economy. Here, he explains the reforms needed to spur business growth and put India on the fast track.

What overarching question were you trying to answer when you began looking at entrepreneurship in India?

My broad question was, to what degree do the patterns that I and others have observed in fast-growing companies in the United States hold true in India and, in particular, in Bangalore? The answer is, not very much. In the United States, many firms start small and stay small. But roughly 5 percent grow quite dramatically. In any metropolitan area, that 5 percent can be expected to grow at a compounded rate of about 15 percent over the next five years. I found in Bangalore that the proportion of firms that grow at this rate is of the order of 1 percent rather than 5 percent.

Another difference is that in the United States the expansion of existing firms accounts for roughly 75 percent more jobs than the birth of new firms. In Bangalore, the jobs created through the birth of new firms are 11 times more than the jobs created through expansions. I further found that to the degree that there are any large businesses at all, they were large to start with. So you see either businesses that have to be started on a large scale or tiny firms that never grow.

My research has focused on businesses outside information technology. IT is exceptional—there, firm growth outpaces firm births, and you see businesses operating on significant scale. But it's a drop in the bucket. Bangalore has a population of 7 million people, which means it has a working-age population of about 3.5 million people. Our best guess is that about 200,000 people work in IT.



"There are clear things that need to be fixed, most prominent among them being the tax system."

—Amar Bhidé

How do high-growth Indian firms compare to their counterparts in the United States?

I interviewed the few high-growth firms that I could find in Bangalore. These were high-growth firms by Indian standards, but not by U.S. standards. Interestingly, firms in both the United States and India start with roughly the same amount of capital: \$10,000 in the United States and about \$8,300 in India. So compared to local incomes, it seemed to take a lot more money to start a business in India than in the United States. Moreover, the U.S. firms grew in five or six years to revenues that were 378 times their initial capital, whereas the Indian firms grew to only about 20 times their initial capital.

And there are other noteworthy differences. In India, there's virtually no ability to use external equity; there's a much greater use of debt. In the United States, young firms try to have as few assets as they can and to subcontract as much as they can. In India, it's the opposite: tiny firms integrate forwards and backwards as quickly as they can. Similarly, these firms are trying to become miniconglomerates before they've reached any scale.

Indian entrepreneurs have much higher working capital requirements. A U.S. entrepreneur can at least hope to collect on receivables in about 30 days. In India, they extend receivables to

Thinking continued on page 4



Thinking continued from page 3

90 days or longer. In the United States, virtually every entrepreneur I studied used rented offices. In India, almost the first thing they do is to acquire the property they are housing their businesses in. Someone might have 80 percent of his capital tied up in real estate and only 20 percent in his business.

This combination of things provides a first-level explanation as to why there are so few firms that grow and why their growth rates are low. There seem to be several things in the environment that have caused this pattern. High on the list is the tax system. India relies much more heavily on indirect taxes than does the United States. These indirect taxes can add up to 32 percent to your cost of goods sold. But small businesses are exempt. So you're better off running 10 businesses, each under \$10 million, rather than having one big business. There's a similar story with labor. Once you get above about 20 people, you can have nonwage costs that add up to 50 percent of a worker's salary.

Another factor is the unreliability of supplies from both government

suppliers and private suppliers. Because you can't count on the electricity supply, you have to have your own generator. Naturally, this ties up capital. Similarly, if you tried to run a virtual business, there would be critical links in the chain that simply would not deliver. Why people invest in land instead of in their business is puzzling. Maybe it's because the businesses themselves are not that profitable. The physical infrastructure is horrible. That means that instead of having one national market of a billion people, you have many little local markets because it's so hard to move stuff from point A to point B. So all these things contribute to creating a disincentive to grow large.

What are the public-policy implications of your research on entrepreneurship in India?

The offshoring phenomenon is neither going to massively disrupt the U.S. economy, nor is it by itself going to transform the Indian economy. If the Indian economy is to get on the Chinese path of growth, it will have to be through reforms that accelerate the achievement of scale and scope in manufacturing rather than by promoting more software development. The actual pool of people capable of performing

these outsourcing services is quite small. There is not a bottomless pit of trained engineers or people who can answer phones to the satisfaction of the U.S. consumer.

There are clear things in India that need to be fixed, most prominent among them being the tax system, which not only discourages businesses from growing to any size but also makes it impossible to raise much by way of taxes. If you can't collect taxes, you can't spend much on the infrastructure. And to the degree that there's pressure to spend, then you get into deficit financing. People in both the government and the opposition now recognize that the system's broken. There's a movement for tax reform, and there is a consensus at the highest levels of the ruling party and the opposition in favor of sensible ideas. But illogical beliefs have created entrenched vested interests against reform.

In terms of the impact of outsourcing to India on the U.S. economy, I would say that the explosion of export-based manufacturing in China is a much bigger deal. The Chinese manufacturing sector has been transformative for China; you can't say this about the software industry in India. Similarly, Chinese exports have had a huge impact on the U.S. economy; they are keeping down interest rates and prices. I don't think the outsourcing of software has had a remotely similar effect. It hasn't hurt many people, and on balance it's a good thing, but it's not a huge thing.

Read More

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Amar Bhidé is the Lawrence D. Glaubinger Professor of Business at Columbia Business School.

Gauging Corruption's Impact

Corruption—a major barrier to growth and development in poor countries—is difficult to define and even more difficult to measure.

Why are poor countries poor? Researchers have long sought geographic, sociological, political and economic explanations for the unequal distribution of wealth among nations. Professor **Ray Fisman** believes corruption is a leading factor in the cycle of poverty in the developing world. But because corruption is so difficult to define and measure, little research has been done on its causes, effects and possible solutions.

“One definition of corruption is illegal use of public office for private gain,” says Fisman. “A slightly different version is the use of public office in a manner that runs contrary to accepted practices. The second definition is highly ambiguous: acceptable to whom?” In the United States, some people might view large campaign donations as a bribe, while others would argue that such donations fall into the realm of accepted practices.

The definition becomes even murkier when you consider managers who use company funds for their own benefit. Some people call that corruption, but Fisman makes a distinction between ethical violations in the private and public sectors. “I think of Enron and Tyco as cases of corporate misgovernance, which is a first cousin to corruption,” he says. “I think of corruption as something that takes place in the public sphere.”

Since bribes and kickbacks are virtually impossible to track, Fisman has devised creative methods for measuring corruption. In the 1990s, he set out to assess the value of political connections in Suharto's Indonesia.

“How do you measure the extent to which political ties matter for firms?”

asks Fisman. “You look at shocks to market value: one minute a firm has valuable political connections, and the next minute it doesn't. You can look at changes in political power after elections, but the problem is that you don't get a lot of electoral surprises. So I looked at the value of well-

connected companies on the days when Suharto got sick.”

Fisman hypothesized that on days when Suharto's health was brought into question—for example, by reports that he would be traveling to Germany for a “health checkup”—firms with close ties to him would see their stock prices drop. The study's findings suggest that political connections accounted for a quarter of the value of well-connected Indonesian firms during the Suharto era. Since the study was published in 2001, other researchers have adapted Fisman's method, using surprise election outcomes to study corruption in various parts of the world.

In a study of tax evasion in China, Fisman and Shang-Jin Wei documented the smuggling of goods from Hong Kong by looking at the gap between the



The study's findings suggest that political connections accounted for a quarter of the value of well-connected Indonesian firms.

declared value of goods leaving Hong Kong and those arriving in China. They found that the size of the gap depended on the tax rate for a particular item: a 1 percent increase in the tax rate corresponded to a 3 percent increase in this “evasion gap.”

Further, they found that much of this effect could be traced to the relabeling of high-tariff products as low-tariff goods. “If chickens are high-tariff goods and turkeys are low-tariff goods, all your chickens would become turkeys,” says Fisman. “We've been able to say something about not just whether illicit activity exists but about the channel through which it takes place.”

One commonly proposed solution to the problem of corruption is raising civil servants' salaries. “There's a psychic cost of corruption, and if you're making more than \$20 a month, maybe you can afford to have a clear conscience,” Fisman says. “But if the society is fairly habituated to corruption so that there's no social sanction or self-immolation, raising salaries won't necessarily remove the temptation to accept bribes. In this case, higher salaries would have to be bundled with enforcement in order to be effective.”

The impact of such a solution is difficult to predict. “The challenge is to come up with a clever way of looking at the effects of wages on bribe taking,” says Fisman. “For example, you could double policemen's wages in one town and

Gauging continued on page 10

Making Globalization Fair

Q & A with Joseph Stiglitz

In discussing the politics of globalization, Joseph Stiglitz, a prominent critic of globalization's shortcomings, offers practical ideas for extending its benefits.

In your recent essay "The Overselling of Globalization," you point out some of the failures of globalization.

The main point is that a lot of the discontent with globalization in places like the United States arises from the fact that it was oversold. It was pretended that everybody would benefit, that there would only be winners, and in fact there are a lot of losers. The problem was made worse by the way we managed it. But even if it's well managed, there will be losers, and it's important to recognize that so you can design policies that respond to those problems.

You argue that today's world has a greater need for collective action to provide global public goods and that such initiatives could be funded through the sale of global natural resources. How would such a plan work?

There's a recognition that there are a lot of global public goods—like fighting against AIDS—that need to be provided globally. Now, some of that is being done informally in joint research programs through voluntary contributions. But without taxation, there would be a tendency for the underprovision of public goods nationally, and the same argument holds internationally for global public goods.

There are also a lot of global natural resources, like the oceans, that really don't belong to any country. The fish in the oceans can be thought of as a global resource. It's a resource that we are overusing, and most economists now say that we ought to sell the right to use this scarce global natural resource. So the proposal is to link

these two ideas: we ought to be using market mechanisms to ensure that our global natural resources are well used; that will generate revenues, and some of those revenues can be used for financing global public goods.

You propose raising the world's money supply by issuing a global reserve currency, which would be distributed primarily to poor countries. How would this plan contribute to the stability of the global financial system?

Bruce Greenwald and I gave a paper at the American Economic Association meetings in January on this idea. The notion is that right now the system that is beginning to weaken involves many countries holding the dollar as reserves. The United States has become the consumer of last resort, and were it not for our huge trade deficit, there might be strong global deflationary pressures.

What we argue is that not only is the system inequitable, it is also unstable. And we see that the huge deficits of the United States are giving rise to a lot of anxiety. Can the United States really continue to run these deficits? Is the dollar a currency that can be relied upon? And that uncertainty about the value of the dollar has contributed to global instability. So our idea is that you would create this global reserve currency, which would eliminate or at least reduce the reliance on the dollar.

You attribute China's success to its strategy of managed globalization—it opened its markets gradually instead of adopting the rapid liberalization policies advocated by the IMF. What advice do you offer to countries that are looking at China as a model?

Well, elements of China's policy are relevant to all developing countries, but obviously China has some distinctive characteristics. So its strategy could not be imitated precisely, but many of the things it has done provide important insights to other countries—for



"Everybody recognizes that one of the great problems of the 21st century is the problem of poverty in the developing countries."

—Joseph Stiglitz

instance, its rural-based development strategy, where a lot of the development occurred in the rural sector so that you did not have the wrenching migration of labor that has been a problem in many developing countries. And it had industrial policies where it promoted a particular industry, just like Korea did. Not all countries can manage those kinds of industrial policies, but Brazil and many other countries can.

In your new book *Fair Trade for All*, you propose that all WTO members commit to providing free market access in all goods to all developing countries that are poorer and smaller than themselves. Briefly describe the benefits of this plan.

Fundamentally, everybody recognizes that one of the great problems of the 21st century is the problem of poverty in the developing countries. There's a lot of discussion about resources—more aid—but they also need more opportunities, and that's what trade does. The cost to the developed countries would be minuscule; in fact, they would benefit, because they would be able to get the goods more cheaply. Obviously there are some special interests in the United States that would suffer, but the country as a whole would actually be better off.

Versions of this have already been adopted by Europe. They have opened up their markets to the poorest countries of the world unilaterally [through the Everything But Arms initiative]. What we

Making continued on page 8

Global Capital Flows and Financial Crises

Q & A with Charles Calomiris

Drawing lessons from recent and historical financial crises, Charles Calomiris offers policy recommendations for managing risk in global financial markets.

Your essay in *Globalization: What's New?* mentions two financial crises that took place roughly a century ago in Russia and Mexico. How did those events differ from more recent crises?

Those were examples of problems in the private part of the financial system, not the government accounts. What was interesting is that the governments of Russia and Mexico had uninterrupted access to international capital markets even during the crises, and they were able to provide support to their domestic financial systems in the form of liquidity. They were able to access the international capital markets as sovereign borrowers because they were on the gold standard. And because they were controlling their own fiscal affairs, they were able to help their banking systems.

What we learned is that if the sovereign has fiscal control, then you don't really need an IMF to assist the domestic financial system, because the sovereign can do it. The reason we can't do that today is because the sovereigns collapse alongside the banks. That happens either because the sovereigns' fiscal problems are the cause of the financial crisis or because the banks are so protected during the crisis that the cost of bailing out the banks undermines the fiscal discipline of the government. If you do a comparison of what emerging market crises looked like 100 years ago as opposed to today, the ultimate lesson you get is we didn't used to have "twin crises"—the simultaneous collapse of a country's banking system and its currency.

Are the frequent financial crises of the past 25 years an inevitable byproduct of an integrated global financial system?

In a sense, yes, because those crises come about from the inconsistency between membership in a globally competitive environment and local crony capitalism. If you use the banks to create insider-connected lending to inefficient firms, the firms still have to compete in a global marketplace. So if you combine international trade with a crony banking system, that brings these two different mindsets together, and something's got to give. If you add capital flows into the mix, you may accelerate that process, because—especially if the local banks are accessing the capital in the form of short-term dollar-denominated debt—the banks may take enormous risks as part of their attempt to desperately prop themselves up and prop up their favored insider borrowers.

Research has shown that access to global capital helps countries with moderately developed economic and financial systems but may hurt countries with rudimentary systems. Should some countries limit foreign capital flows, and if so, how?

I think the answer is you should try to reform the domestic financial system to get rid of the perverse incentives toward taking risk and subsidizing crony capitalists. That's the proximate source of the problem, so the solution is obviously to address the real problem. What if you can't address that problem? Then I think there's a legitimate argument for trying to limit short-term, hard-currency-denominated capital flows, but not to shut out all forms of foreign capital. So I would come to it as a last resort.



“In an emerging market country, fiscal reform is

the sine qua non—you can't have liberalization without it.”

—Charles Calomiris

What lessons should investors and policymakers draw from the 2001 Argentine crisis?

The Argentine crisis was a failure to fulfill the promise of reform. Argentina established a sword of Damocles—something hanging from a thread over its head—in the form of the convertibility system and complete openness of capital markets and a whole variety of things that only made sense as policies if other changes were going to happen. One of the other changes was fiscal reform. Argentine labor laws also made the country very noncompetitive. The problem was that the government never completed the most important parts of the reform program. What that meant was that as time wore on, capital was no longer willing to come to Argentina.

The real lesson is that you can't do things in pieces. In an emerging market country, fiscal reform is the sine qua non—you can't have liberalization without it. Argentina fixed its banking system, but then at the same time it forced the banks to stuff themselves with government debt—because no one would buy the government debt outside the country—so the government twisted the arms of the pension funds and the banks and, of course, brought the banks down with the currency. The fiscal problem is the central problem, because if you don't fix it, it contaminates even the things you have fixed.

Global continued on page 8

are proposing is to extend this so that it's not just Europe but also America and Japan, and extending it to more countries. So it's not just the very, very poorest, but some of the other low-income countries.

What kind of response has the book received in policy circles?

The book has gotten a very strong response, especially from the developing countries, but even from policymakers in more-developed countries. The book was launched at the Hong Kong ministerial meeting on trade in December, and it was very positively received. Coverage in Asia was enormous. It obviously spoke to concerns that many of these countries have.

What the book points out is that trade can be an important element in promoting development but that the development round that was begun in Doha [in 2001] is not a true development round. A lot of the discussion is focused on agriculture. We show that there's a broad agenda that goes well beyond agriculture and that would be of benefit to more countries. Eliminating [agricultural] subsidies would actually hurt some of the poorest countries, because they are food importers. We point out that, in fact, there is a broad agenda and one which is in some ways more intellectually coherent than the kind of trade position that the United States has maintained in these negotiations, where it has been trying to go so far as to claim that cotton subsidies are not trade-distorting.

One of the disappointments at Hong Kong is that while there's a broad agreement on the principle of Everything But Arms opening up markets, the United States wants to carve out exceptions so that some of the poorest countries, like Bangladesh, would not be able to export to the United States their key commodity, textiles and apparel. So what [the U.S. government says] is they can export to the United States aircraft—things that they can't produce—but things that they do

produce, that are their comparative advantage, we want to restrict those. And obviously the developing countries see right through that kind of duplicity.

Can you comment on the process of multilateral trade negotiations? You make the point in the book that the system is inherently disadvantageous to developing countries because it's based on the principle of reciprocity.

One of the seminars in Hong Kong concerned the strategy of the United States and a few other countries of signing bilateral agreements, which are clearly undermining the multilateral system and are even more unfair than the multilateral system. So yes, the multilateral system is complicated and in some sense disadvantages the developing countries, but they are even more disadvantaged in the bilateral agreements. One of the points, though, that we do emphasize is that because of this inherent unbalance, it's important that trade negotiations focus on the core issues of trade and not extend into areas like intellectual property.

Read More

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Joseph Stiglitz is university professor at Columbia University and executive director and cofounder of the Initiative for Policy Dialogue. He received the 2001 Nobel Prize in economics for his pioneering research on the economics of information.

What steps should the IMF take to restore proper risk management to global financial markets?

The IMF needs to become a source of liquidity to mitigate the fallout that comes from financial crises. In particular, if country No. 1 has a major fiscal problem that makes it suffer a twin crisis, the IMF's main obligation should be to look at what the ramifications are going to be for other countries. One of the things the IMF needs to do is to

In *Globalization: What's New?* (Columbia University Press, 2005), 10 notable scholars, including Joseph Stiglitz and Charles Calomiris, offer diverse viewpoints.

provide a rapid liquidity infusion on a coordinated basis to prevent the non-crisis-starting countries from suffering their own crises.

There are going to be some crises that might not be ultimately from insolvency. In those cases, being able to provide liquidity in a way that doesn't encourage the use of IMF lending for bailouts could also be very helpful in preventing crises, not just in third-party countries but also in the country that's experiencing the fundamental problem.

So my emphasis has been on creating mechanisms at the IMF that are geared toward that kind of liquidity provision. Banks in the United States do this with lines of credit, and we have ways of giving a borrower access to a line of credit but still making sure that the circumstances are appropriate for the use of that line of credit. I believe we could do that with a sovereign, and I think that's what the IMF really should be thinking about.

You also need to have the right internal governance so that the IMF abides

by the rules it establishes. My view is that the IMF as it's currently constituted is simply too politically motivated. We used to think we wanted the IMF to be an agent of coercion to enforce something called the Washington Consensus of the G7. Well, we don't have a Washington Consensus, really. If you start looking around the world, Korea's a pretty important country, India's a pretty important country, China's a pretty important country, Russia's a pretty important country, Mexico's a pretty important country, Brazil's a pretty important country. But none of them is in the G7.

The whole model of the slush-fund entity that we use as our agent to achieve our political objectives doesn't make much sense if our political objectives are so heterogeneous. So we really have to change our mindset to make the IMF an effective mechanism, because, first of all, I don't think it should be a political tool. But I would also say it can't be a political tool, because the G7 no longer has a monopoly over political will.

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Charles Calomiris is the Henry Kaufman Professor of Financial Institutions and academic director of the Jerome A. Chazen Institute of International Business at Columbia Business School and academic director of the Columbia University Center for International Business Education and Research.

Small Firms' Access to Credit in Emerging Markets

In the 1990s, Argentina adopted world-class bank regulation and welcomed the arrival of large foreign banks. Did these changes make it easier for small firms to obtain funding?

After the 1995 "Tequila Crisis," Argentina put in place a state-of-the-art banking system reflecting the latest recommendations of the Basel Committee on banking supervision. By 1999, the country had experienced several years of rapid growth, fueled in part by capital from large global banks that had recently entered the Argentine market. But

did the entry of foreign banks and the introduction of strong regulation improve small firms' access to capital? Since small firms are a leading driver of growth in

developing countries, the answer to this question has important implications for all emerging markets.

To study small firms' access to capital, Professor **Daniel Paravisini** set out to determine whether local Argentine banks faced liquidity constraints and, if so, how those constraints affected small firms. Bank regulation is only one of several factors that could contribute to creating liquidity constraints. Still, evidence of such constraints would suggest that stringent regulation might have adverse economic consequences, and that regulators should weigh those consequences against the goal of preventing a financial crisis.

If banks are unconstrained, they will fund all investment opportunities with a projected rate of return higher than

the banks' marginal cost of capital. But if banks are constrained, they will pass up some profitable investment opportunities, to the detriment of the economy. In seminal research on the Great Depression published in the 1980s, Federal Reserve Chairman Ben Bernanke showed that liquidity constraints in the banking sector magnify recessions and exacerbate negative shocks to the economy.

To test for such constraints in Argentina, Paravisini examined loan data from 1999, a year in which the Inter-American Development Bank provided

lending credits to Argentine banks in an effort to stimulate the small-business sector. In a related research project, he found that when development agencies use local banks to distribute tar-

If banks are constrained, they will pass up some profitable investment opportunities, to the detriment of the economy.

geted lending credits, the banks tend to reallocate the money—for example, by relabeling existing small-business loans as program loans—so that only a small fraction of the program funding actually reaches the target sector. The Argentine data showed a pass-through rate to the target sector of just five to eight cents on the dollar.

So what did the Argentine banks do with the rest of the money? "One possibility was to give it back to shareholders or reduce other debt at the market price," says Paravisini, "but in fact they lent out 60 or 70 cents on the dollar." If banks are unconstrained—that is, if they are already funding all profitable investment projects available to them—a positive liquidity shock will not induce them to expand their

Small continued on page 10

lending. So the fact that the Argentine banks were actually lending out most of the program funding—albeit not to the target sector—proves that they had previously faced liquidity constraints. Moreover, the banks' risk profiles did not change when they expanded their loan portfolios, a finding that suggests they had been passing up profitable lending opportunities.

Even if small banks are constrained, shouldn't the arrival of large foreign banks make it easier for small firms to get funding? Not necessarily, says Paravisini. Commercial-banking markets tend to be segmented, with large banks lending to large firms and small banks lending to small firms, so an entrepreneur

Daniel Paravisini's research suggests that regulators should consider the impact of rigorous regulation on the small-business sector.

neur who has been turned down by a local bank isn't likely to get a loan from Citibank. Furthermore, frictions related to information often prevent borrowers from switching banks. "If I'm a lender and you're a small firm, when I lend to you, I get to know things about you that other banks don't know," Paravisini says. "If anyone's going to be willing to lend to you, it should be the bank that knows you, so if you try to move, this gives other banks a bad signal." Thus the entry of foreign banks into an emerging market may not improve small firms' access to capital.

Further research is needed to separate the effects of regulation from other factors contributing to the liquidity constraints of small banks. But Paravisini's research suggests that regulators should consider the impact of rigorous regulation on the small-business sector. "If small banks are constrained due to regulation, because there are very tight capital requirements or they're forced to issue subordinated debt, then this is just a cost of having appropriate regulation," he says. "The purpose of regulation, in the end, is to avoid financial crises. If banks being liquidity constrained is a consequence of this, then it's a cost you have to balance against the benefits of preventing a financial crisis."

Read More

Paravisini, Daniel. "Constrained Banks, Constrained Borrowers: Bank Liquidity Constraints and Firm Access to External Finance." Working paper, Columbia Business School, 2005.

Paravisini, Daniel. "Targeting Credit Through the Banking System: Does It Work?" Working paper, Columbia Business School, 2005.

Daniel Paravisini is assistant professor of finance and economics at Columbia Business School.

not another, and then drive around the two places and see how many times you get pulled over and asked for a bribe. You need a roundabout way of making an assessment."

Some people have argued that corruption is not always detrimental to development. The Asian Tigers, for example, have grown rapidly for decades, crony capitalism notwithstanding. More research is needed to determine what types of corruption are more or less damaging than others.

"If there's a list of prices and everyone knows how much it costs to get something done, that's probably less damaging than a case where corruption generates uncertainty," says Fisman. "We don't know a lot about where corruption is most damaging. Much of Southeast Asia and East Asia has high levels of corruption, but in spite of that, those countries are generally economic success stories, and they have respectable distributions of wealth."

The greatest challenge for researchers in the area of corruption is to develop practical methods for measuring it and assessing its impact. "This whole literature is in its infancy," Fisman says. "There's a need to build on the methodology to answer the questions we care about: What are the effects of corruption and what can we do about it?"

Read More

Fisman, Raymond, and Shang-Jin Wei. "Tax Rates and Tax Evasion: Evidence from 'Missing Imports' in China." *Journal of Political Economy* 112 (2004): 471–96.

Fisman, Raymond. "Estimating the Value of Political Connections." *American Economic Review* 91, 4 (2001): 1095–1102.

Ray Fisman is associate professor of finance and economics at Columbia Business School.

Research Brief

The Idea: Chinese consumers judge brand names in other languages by the sound and meaning of the names' Chinese equivalents.

THE RESEARCH

Shi Zhang and **Bernd Schmitt** designed a method for determining how bilingual consumers understand messages in both languages and tested it among 368 students at Nankai University in China. All students spoke Chinese fluently, while half scored high on an English test and the other half scored low. The study asked them to rank the quality of dual brand names, where the English letters and Chinese characters appeared in the same rectangular frame. The products were lotion, tissues, boxing gloves and a supermarket store.

The results showed that when you put the English name first or tell the consumer that's your focus, it matters whether the sound of the name in English matches the sound in Chinese. This finding was even more true for the group with better command of English. When you put the Chinese name first or tell the consumer that's your focus, it matters more whether the meanings of the two words match. This pattern was equally true for both groups of students.



PRACTICAL APPLICATIONS

Global marketers who sell to China

You can use this research method to evaluate names and even headlines, taglines and ads that you plan to translate into Chinese in your global campaigns. Chinese consumers are increasingly proficient in English to some degree, and this method

helps you determine what combination of English words and Chinese characters best suits your target market, based on the consumers' level of fluency in English.

Chinese marketers who sell to other countries

As Chinese companies increasingly market outside China, they must switch from meaning to sound—that is, from characters to words. This is a fundamental difference between written Chinese and most other major languages.

This research method can help you make translations into English or other target languages or choose original product names in Chinese that resonate with both Chinese and non-Chinese consumers.

Read More

Schmitt, Bernd, and Shi Zhang. "Activating Sound and Meaning in Brand Name Evaluations: The Role of Language Proficiency in Bilinguals' Differential Processing." *Journal of Consumer Research* 31, 1 (2004): 220–29.

Bernd Schmitt is the Robert D. Calkins Professor of International Business and executive director of the Center on Global Brand Leadership at Columbia Business School.

This method helps you determine what combination of English words and Chinese characters best suits your target market.



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