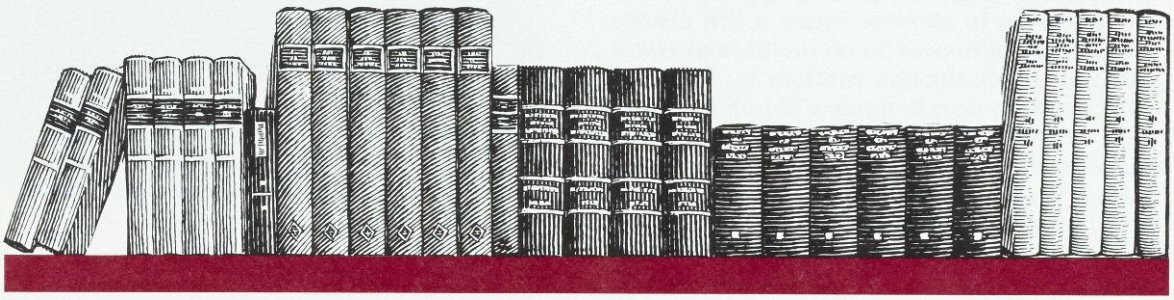
Book Review

Old South, New South: Revolutions in the Southern Economy Since the Civil War

by Gavin Wright
Basic Books, New York, 1986.
$19.95.



Economists and historians agree that the southern economy performed poorly after the Civil War. The destruction of life and property during the war and initial confusion about how agricultural production should be reorganized help to explain the dismal economic conditions immediately after the war. The recovery, however, was prolonged and perhaps incomplete. By 1880 southern commodity output per capita was still 21 percent below its 1860 level, and it was not until the beginning of the twentieth century that it had returned to its 1860 level.

Explaining the long-run pattern of decline and recovery of the postbellum southern economy has proved more difficult and complex than explaining the immediate post-Civil War pattern. Most economic research in recent years has emphasized the agricultural sector, proceeding along several paths. The explanations for the South's poor performance after the war include the rise of monopolistic and exploitive credit markets, a large withdrawal of labor by blacks, a shift away from agricultural self-sufficiency towards production of cotton for the market, and a slowdown in world demand for cotton. Emancipation without redistribution of land to freedmen has also been suggested as a cause of weak credit markets and a contributor to the development of family sharecropping.

In *Old South, New South*, Gavin Wright brings an extensive and diverse collection of economic evidence to the debate on the economic development of the South after the Civil War. To coordinate the abundance of information, Wright introduces the theme of a southern labor market isolated from the rest of the nation, a labor market characterized by unskilled labor and low wages operating independently of influences from the North. New Deal legislation helped to bring the southern labor market into contact with the national market by establishing minimum wages and other measures that made industries based on unskilled labor less attractive to investors. The South began welcoming new industries from the North, which eventually led to the economic rebirth of the region.

To understand the causes of the South's low-wage, isolated labor market, Wright looks first at the role of slavery. Slaves, according to Wright, were valuable assets, and they were easily moved to the more productive states like Mississippi, Louisiana, and eastern Texas to take advantage of more fertile soil. Wright contends that because their wealth was primarily in the form of slaves, planters had few ties to a local area and little incentive to make long-term investments in other assets like land improvement, community development, or education.

Such investments would improve land values, but they would not add to the value of slave capital. Thus, the antebellum South was marked by a lack of towns and schools. Cotton production on plantations that were often self-contained communities was emphasized, while diversification into other natural resources like iron, various minerals, and timber was neglected.

Emancipation turned the South's specialization in cotton and slave labor into a liability. Land became the planter's primary asset, and cotton production became even more important because it was the crop that yielded the highest value per acre. The former slaves became part of a low-wage, unskilled labor force that was mobile within the South but isolated from the higher-wage northern labor force. Much of the labor force was engaged in agriculture as sharecroppers, an arrangement that had evolved after planters and freedmen realized that cash wages could not be paid regularly owing to a lack of ready cash. The lack of investment in schools and community development before the Civil War contributed to the persistence of the unskilled labor force after the war. There was remarkably little migration into or out of the South until the turn of the century, when blacks began migrating to the northern industrial areas.

The isolated labor market affected the choice of technology and output in various industries. The expanding textile industry was labor-intensive and for a long time tended to produce coarser and more basic materials. Because of abundant low-wage labor, the southern textile industry dominated the New England mills by 1910-20. The iron and steel industry in Tennessee and Alabama manufactured mostly pig iron that was later processed in northern plants. The South had little success in shifting into modern methods of steel-making, partly because of an unskilled labor force. Wright argues that little incentive existed to develop capital- or machine-intensive technologies and processes. Cotton harvesting could have been mechanized sooner, but the economic incentives did not yet exist in the nineteenth and first half of the twentieth centuries. It was cheaper to use unskilled labor. It was not until 1970 that virtually all cotton was mechanically harvested. As late as 1960, about half was still harvested by hand. Wright adds that the South had little incentive to invest in the education of its citizens because workers with increased skills could command higher wages. Unfortunately, they would probably migrate to the North, where wages were higher, rather than stay in the South, where business was unwilling to pay higher wages, and the South would have nothing to show for its investment.

The New Deal and World War II brought the isolated southern labor market into contact with the national market. Minimum wage laws were particularly effective in raising wages in the South, giving workers whose jobs were eliminated by higher wages the incentive to move north. Subsidies and benefit payments created by the Agricultural Adjustment Act in 1934 gave planters more reason to eliminate tenants and wage laborers. The displaced agricultural workers had no place to go because minimum wage laws effectively prevented southern industrialists from hiring them as well. Many unskilled workers, whites as well as blacks, migrated north in hope of finding work. With the elimination of a distinct southern labor market, the South welcomed flows of outside capital and skilled labor into new and modern industries. By the 1950s southern communities were actively recruiting northern industry. Some had started as early as 1937. The result we see today is a completely new economy developing in the shell of one that no longer exists.

Wright's theme of an isolated labor market coordinates the detail in *Old South, New South* effectively. It also leaves one asking for more. The term "isolated" suggests that barriers prevented labor from entering or leaving the South, but what these barriers may have been is vague. Northern perceptions of racism and slavery may have made the South an undesirable place to live, but they did not prevent Northerners from developing significant financial contacts in the antebellum South. The sense in which the southern labor market was "isolated" is unclear. There were no legal restrictions or trade sanctions imposed on trade with the postbellum South. Indications exist that railroad freight rates discriminated against the South, but this has been disputed by some economists. Others have pointed out that declining transportation costs in general in this century helped to bring the South into the national economy. Jim Crow laws enacted around the turn of the century were an attempt to restrict black mobility, but they were also a reaction in part to the migration of blacks to northern cities. White landowners and industrialists were fearful of losing their source of cheap, unskilled labor. Even so, they did not prevent blacks from migrating by the thousands to the North. Finally, without slave

labor, the South's extraordinary ability to produce cotton profitably and efficiently was lost; what replaced slave farming after the Civil War provided little incentive for migrants to settle in the South or for northerners to continue lending capital there. However, the fact that the South was poorer than the rest of the nation after the Civil War does not establish that it was isolated.

There is little doubt that the southern labor force was less skilled and, hence, more limited in opportunities, than the northern. That the southern labor force was unskilled and poorly educated, however, was probably due in part to the large proportion of former slaves in the population; these individuals would have received no education while they were enslaved, regardless of how mobile slave owners had been or how unwilling to invest in schools (presumably for whites only) or community development. If slaves and owners had not been mobile, it is hard to believe that the labor force would have been much better educated and more skilled. The transience of planters and mobility of slaves does not really explain why the southern labor force remained unskilled after the Civil War. A similar westward migration before and after the war was taking place in the North, with farmers from older, less productive farms in the East and foreign immigrants moving to the new and more productive land of the Midwest. Their mobility did not prevent them from setting up schools or developing communities.

Wright's emphasis on an isolated labor market at times obscures other economic factors that help to explain the development of the Southern economy and also the distinctiveness of the Southern labor force. A poor credit market and less productive land tenure arrangements are two such factors that Wright and others have presented that are worth further elaboration. The system of sharecropping that replaced slave farming after the Civil War and continued into the 1930s was far less efficient and profitable. In short, emancipation eliminated a valuable source of wealth and collateral as well as a profitable method of production for some southerners.

Wright also intentionally keeps the level of statistical analysis low so as not to discourage the general reader. The lack of some simple time-series or correlation analysis of northern and southern wage rates, however, frustrates our understanding of the sense in which the southern labor market was isolated. If southern wages tended to move with northern wages, this would indicate that perhaps both regions had labor markets that were either linked or responding to a common set of influences. Showing that southern wages were simply lower than northern wages does not really establish the fact that the South was isolated. It is the degree of co-movement that is of real interest here. Perhaps the postbellum South was isolated in the sense that it was an area with little profit opportunity rather than an area that was inaccessible to investment or labor flows.

Wright suggests that the book chronicles the history of an economy that no longer exists; he provides few policy implications for future growth. Nevertheless, he points out that the new South is part of a larger, global economy, and he warns that reliance on economic forces alone is not enough to assure social justice. In particular, he points out that while historically blacks have been excluded from many skilled and professional occupations, the increasing importance of white-collar, high-skill, high-tech occupations may exclude unskilled and minority people from economic advancement even more than in the past. Continuing direct effort by government to bring these people into the expanding economy will be necessary.

In spite of my concern over the term "isolated," *Old South, New South* should be read; it brings together many separated strands of research in a thought-provoking style that is accessible to the general reader as well as the economist.

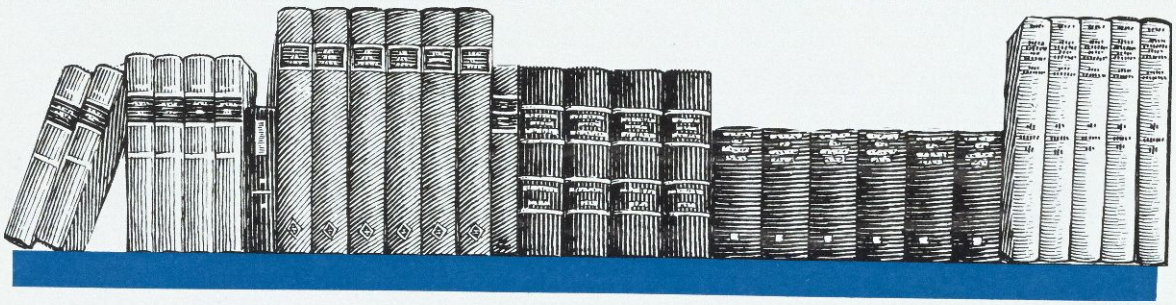
—Jon Moen

The reviewer, a specialist in labor markets, is an economist in the regional section of the Atlanta Fed's Research Department.

Book Review

Rational Expectations and Inflation

by Thomas J. Sargent
New York: Harper & Row, 1986. 212 pages.
$9.00



The message contained in Thomas Sargent's *Rational Expectations and Inflation* is quite clear: inflation is not really a monetary phenomenon; that is, it has little to do with inappropriate changes in the quantity, per se, of money. The real culprit behind an increasing price level is a decrease (or an expected decrease) in the value of assets that back the money supply. As such, this book breathes some new life into the Real Bills doctrine, though in a rational expectations framework, implying that money, like any other financial instrument, gains its value by the assets behind it.[1] The Real Bills doctrine, at least as interpreted by Sargent and some others, holds that if the money supply is backed by "real" assets, then price level stability, among other things, will not be a problem.[2]

The book is a collection of six related essays, written on a level accessible to undergraduates. It centers on the problem of the interaction ("strategic interdependence") of fiscal and monetary regimes and their resulting impact on the price level. It can be loosely divided into three, two-chapter sections.

The first third of the book contains two essays concerning the implications of rational expectations for mainstream macroeconomics. Sargent finds fault with models that do not regard an individual's or an institution's economic behavior as a function of the policy regime—"the rules of the game"—and provides a rather interesting analogy to the National Football League. A change in the rules of the game will lead to compound changes in behavior, and these changes will invalidate the results of any model that does not take into account the effect of the policy regime along with other factors. Sargent argues that the insights of rational expectations require macroeconomics, including econometrics, to be forward-looking enough to see fundamental changes of behavior resulting from changes in policy.

The text goes well beyond this problem, a simple generalization of the "Lucas critique."[3] Sargent also addresses the issue of the credibility and sustainability of policy regimes once announced, as well as associated changes in macroeconomic behavior given the eventual outcome of the regime. It is in this respect that inflation stops being a monetary phenomenon.

Sargent's second chapter, "Reaganomics and Credibility," argues that a continuous series of large deficits cannot persist indefinitely when accompanied by a tight monetary policy. Rather, he contends, the deficit regime must be expected to ultimately end or result in an increase in the base money supply as the fiscal authority finds it has progressively more difficulty marketing its growing supply of bonds. (In view of

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recent U.S. experience, this discussion is quite timely.) It comes down to a game of "chicken"—either the fiscal authorities stop deficit spending, or the monetary authorities relax their grip on the money supply, and agents must guess who will be the first to back down.

This analysis implies that a change in policy must be evaluated not simply on its own, but also by what the new policy portends for future *changes* in policy. Not only do agents modify their behavior as a result of a change in policy; they also recognize the constraints that the new policy may place on future regimes and modify their behavior now as a reaction to what is perceived as being a necessary policy change in the future.

The second third of the book contains two historical essays concerning the problem of ending inflation. Sargent examines one episode of moderate inflation and four periods of hyperinflations (all inter-war, European). He finds that, in these cases, a change in fiscal regime, *not a change in monetary policy*, brought the inflations to quick and rather costless ends, that is, with no prolonged bouts of increased unemployment. The ends of the four hyperinflations were characterized by a rapid stabilization of the price level that accompanied a credible change in fiscal policy away from clearly uncontrolled deficits. The money supply itself continued, in each of the cases studied, to grow at quite remarkable rates for extended periods of time. The vast increase in the supply of money did not have any impact on the price level; Sargent attributes this to the change in the backing of the money—away from clearly worthless government debt toward private debt that was backed by real assets. Sargent thus makes a compelling case for the Real Bills doctrine.

The final third of the book contains two essays that probably would have been better placed with the first and second thirds of the book, respectively. Chapter 5, "Some Unpleasant Monetarist Arithmetic," is the now familiar article wherein Sargent and Neil Wallace argue that a continued deficit (factoring out interest payments) is not compatible with a tight money policy if the rate of interest is greater than the economy's growth rate. As a result, if fiscal policy "dominates" monetary policy, expectations about future money growth, and hence future inflation, will result in higher rates of inflation.

The last essay, Chapter 6, contains some interesting speculations regarding currency depreciation in Hong Kong. Sargent, with David J. Beers and Wallace, contends that the drop in value of the Hong Kong dollar during the early 1980s may have been the result of the uncertain value of the assets backing loans in financial firms' portfolios. This uncertainty, they argue, may be due to the possible change in ownership of Hong Kong, coming with the expiration of the British lease of the territory. Inflation then may be welcomed by the financial community, for it lowers the real value of firms' liabilities as the value of their assets drops. In effect, inflation divides the asset value loss of financial institutions between the firms themselves and their depositors. The depreciation of the currency may be serving to "smooth the Hong Kong economy's adjustment to lower real property values in terms of foreign currency" (p. 202).

Overall, *Rational Expectations and Inflation* should serve to rekindle interest in the Real Bills doctrine. My only regret is that Sargent did not include "The Real Bills Doctrine vs. The Quantity Theory: A Reconsideration" (*Journal of Political Economy*, 1982, with Neil Wallace), though I suspect this was in keeping with trying to make the book as accessible as possible. At the very least, this text focuses attention on the importance of non-monetary (particularly fiscal) developments in making monetary policy. For those interested in policy issues or inflation, this book is well worth reading.

—Thomas J. Cunningham

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NOTES

[1]"Rational expectations" assumes that people form their expectations on the basis of all available information. Some of the far-reaching implications of this approach, which gained acceptance in the 1970s, are detailed in the text.

[2]Not everyone agrees; there are other interpretations of the Real Bills doctrine and other facets to this interpretation, though the money/price relationship is, I believe, the most important for the present discussion. Whether or not there is any agreement on the specific form of the Real Bills interpretation, most economists hold the doctrine, though not necessarily in this specific form, in disrepute, either because of price level instability, procyclicality problems, or some combination of both. Further, it should be added that "real assets" do not necessarily imply, say, a gold standard.

[3]Robert E. Lucas, Jr., "Econometric Policy Testing: A Critique," in *The Phillips Curve and Labor Markets,* edited by Karl Brunner and Allen H. Meltzer (Amsterdam: North-Holland, 1976), pp. 19-46.

Book Review

In Whose Interest? International Banking and American Foreign Policy

by Benjamin J. Cohen.
New Haven and London: Yale University Press, 1986. 347 pages. $19.95.

What role did bankers play in gaining release of the American hostages in Iran? Did American banks' financial stake in Polish loans constrain U.S. support of the labor union Solidarity? Has American foreign policy in the Middle East been affected by Arab deposits in our nation's banks? How have Latin American loans complicated U.S. foreign policy in that region? Conversely, how have foreign policymakers helped to determine the international activities of American banks in all of these instances?

Benjamin J. Cohen addresses these questions and many others in his far-reaching analytical study, *In Whose Interest? International Banking and American Foreign Policy.* Benjamin Cohen is Professor of International Economic Affairs at Tufts University's Fletcher School of Law and Diplomacy. The book was commissioned by the Council on Foreign Relations, "a nonprofit and nonpartisan organization devoted to promoting improved understanding of international affairs through the free exchange of ideas."

Today, international banking and international politics are inextricably entangled. What makes the matter most interesting and most complex is that, although international bankers and the makers of foreign policy share the same turf, they are not playing the same game. Banks are rightfully profit-motivated; foreign policymakers have an agenda that includes other national interests. "The essence of the problem," Cohen writes, "is that bankers and policymakers do not share all the same motivations or goals. While their activities have become increasingly intertwined and interdependent, a potential for conflicting interests exists—and such conflict could severely handicap the public authorities in their ability to formulate and implement an effective foreign policy" (p. 4).

Recent events, most notably the Latin American debt situation, urgently bespeak our need to understand the relationship between international bankers and foreign policymakers. Cohen's book is a response: "[It] is written in the hope of promoting better general understanding of the complex issues involved in bank-government relations in the foreign policy area" (p. 5). Toward this end he succeeds.

Cohen has produced an informative, even-handed treatise that deals comprehensively with the interrelatedness of international banking and international politics. The book is void of histrionics. Not only is Cohen's style more sober and academic than that, but the subject matter simply does not call for an account of intrigue and conspiracy. Cohen explains convincingly why "conspiratorial social theories . . . have little intellectual or empirical substance" (p. 60). Banks' direct efforts to influence government as it forges foreign policy or, on the other hand, direct attempts by government "to shape the commercial decisions of banks" are rarely rational strategies in the overseas arena. Con-

siderations of effectiveness, efficiency, equity, and external relations, "the four e's" as Cohen calls them, serve as restraints.

Indirect influences are the more fundamental factors governing interactions between international bankers and policymakers. "Inevitably, if unintentionally, each side has an impact on the decision-making environment of the other through the ongoing pursuit of its own legitimate responsibilities and objectives" (p. 68). Cohen goes on to add: "Banks may have become more sensitive to noneconomic (political) considerations and influences and increasingly factor these into their ongoing commercial decisions. Banks, conversely, through their ongoing commercial decisions, may have impacts on the general foreign policy environment that alter the issues of salience for policy and/or the nature and scope of policy options available to government officials" (p. 59). The analysis of the book is focused on this more subtle but richer type of interrelationship.

Cohen couples his theoretical analysis with a historical discussion. Reaching as far back in time as ancient Babylonia, he recounts the rise and fall of history's great banks through tales that are both entertaining and illuminating. Parallels are easy to draw between events of the past and conditions today. For example, debt crises arose in the fourteenth century and again in the fifteenth century as the world's most powerful banking houses, then in Florence, faced default on loans to a then-developing country—England. In the seventeenth century the Hapsburgs could not repay their debts, a development that shook the Fugger bank of Germany. By the nineteenth century British banks took their turn at losing money on sovereign loans; the debtors were the newly independent nations of Latin America.

The author's historical digression serves two purposes. First, it puts into perspective the events of the "Incredible Quarter Century" (1957-1982) when international banking seemed to emerge and take off. International banking and lending to sovereign states are not new phenomena; their problems and pitfalls have been experienced before. History reveals a cycle of boom and bust in sovereign lending, followed by retreat from international banking. Subsequently, when the previous history has been forgotten, the cycle begins afresh.

Second, Cohen draws valuable lessons from the historical discussion. He emphasizes—and it must be emphasized—that international banking and lending to sovereign states are not inherently bad. On the contrary, mobilization of capital is extremely important for world prosperity. In order to grow, developing nations need investment funds, which cannot always be raised domestically. Foreign investors, on the other hand, benefit from the high returns development promises. The lesson to draw, rather, is that international banking, and sovereign lending in particular, is inherently dangerous. Sovereigns are not always good credit risks. Certainly countries do not go bankrupt, out-of-business, and into oblivion the way firms might, but it is precisely because they risk no financial death penalty that independent nations are often less restrained in their borrowing than they ought to be.

The historical experience, according to Cohen, yields further lessons in relation to the shortcomings of lenders. Cohen calls for increased regulation of international financial activity "to temper the drives that naturally result from the intensity of competition in the financial sector. Lenders' animal spirits must be kept firmly in check" (p. 115).

"International banking and lending to sovereign states are not new phenomena. . . . History reveals a cycle of boom and bust in sovereign lending, followed by retreat from international banking."

Analyzing the historical record, Cohen notes that "foreign lending manias have been closely associated with an oversupply of capital. Investors have been driven to find outlets for surplus funds" (p. 116). He therefore recommends more restraint on the part of governments in their management of liquidity. From the standpoint of economic theory, this observation is one of Cohen's most interesting contributions. Traditional monetary theory dictates that, as liquidity increases, funds are directed to investment projects offering highest returns, and any surplus funds are channeled to those with slightly lower returns. By satisfying the need for credit in the highest returning projects, an expansion of liquidity draws down the marginal productivity of capital and thus brings down

interest rates. Cohen's point is that surplus funds, rather than flowing to lower yielding projects, instead flow to riskier projects. On a risk-adjusted basis, interest rates will be lower, but the aggregate portfolio of investments will certainly be riskier. One way government can manage systemic risk, therefore, is via restraint in monetary policy. Cohen's argument is unconventional yet plausible, one that warrants further empirical research.

Four case studies illustrate the complex interactions of high finance and high politics in the modern era. Cohen describes and analyzes 1) the threat that Arab deposits in American banks could be manipulated to disrupt our domestic economy, 2) the Iranian hostage episode during which Iranian assets in U.S. banks were frozen, 3) the Polish debt crisis coinciding with the suppression of rights in Poland, and 4) the Latin American debt situation. In intricate cases such as these, international bankers and policymakers sometimes hinder one another and at other times support one another. At all times they must be aware of one another.

"Foreign policy ends are served when international financiers do not overextend, and economic ends are served when government officials refrain from intervening."

Cohen concludes his study with several prescriptions. "The ultimate goal is maximization of joint benefits. If the relationship between bankers and foreign policymakers cannot be ignored, why not, then, make the most of it?" (p. 280). To do so, he asserts, requires enhanced information, communication, and moderation. International bankers and government officials must gather and share pertinent information. Second, they must engage in a "structured dialogue" through which the two parties can discuss conflicts and mutual interests in a forward-looking manner. Such communication would enable them to plan strategically, eliminating the steady need to deal extemporaneously with problems stemming from past mistakes. Third, Cohen admonishes bankers and governments alike to curb their excesses and practice moderation. Foreign policy ends are served when international financiers do not overextend, and economic ends are served when government officials refrain from intervening.

The author labels these recommendations "an ounce of prevention," adding, however, that existing problems require "a pound of cure." The stubborn Latin debt crisis, Cohen claims, is an example of a market failure and consequently warrants government initiative. The solution to the global debt crisis is negotiated settlement wherein burdens are shared by all parties. This may seem unfair, but, as Cohen reminds us, the poor judgment that caused the problem was exercised by all parties, too. And, of course, he adds that a reduced federal budget deficit would bring down interest rates, thus making Third World debt service more manageable.

Cohen's work is indeed remarkable. He organizes a vast body of information, analyzes it, draws inferences, and relates these inferences to the pressing problems of today. Nonetheless, the author leaves room for marginal improvements. First, he limits the scope of the analysis to banks. Banks are special, according to Cohen, because they are highly leveraged and because their successes or failures have systemic implications. Granted, Cohen defines banking through function and not form, and thus includes some financial institutions that have increasingly entered into bank-like activities. But he excludes still other kinds of firms that are vulnerable and whose failures also would jeopardize the greater economy's health. Congress bailed out Chrysler and Lockheed when prospects of their bankruptcies threatened systemic well-being. When such industrial firms invest directly overseas, and when foreign multinationals buy assets inside the United States, do they not then satisfy the same criteria for special consideration that Cohen laid down for banks?

Calls for self-restraint by banks and for stricter supervision both are problematic. Theoretically, banks act in their own self-interest. A vague directive to practice self-restraint, which is equivalent to acting against one's own self-interest, cannot succeed. The request for stricter supervision, however, also misses the mark. Observations that banks may have acted imprudently in the past motivate Cohen's call. But, as he has shown, it is in an individual bank's own best interests to act prudently. If the profit motive does not encourage appropriate caution, then the challenge is to identify the rea-

sons for this market failure. Regulators then can intervene minimally, altering the market environment just enough to prevent the failure.

Cohen argues that banks were myopic in their lending practices, partly because managers were enticed by quick short-term profits accruable before those managers moved on to different jobs. A more likely explanation is that bank accounting standards and reporting practices bias managers toward seeking short-term returns. In either case, the questions arise: Why do bank stockholders and boards of directors allow such behavior? What minimal intervention would alter the incentive structure and thereby eliminate the inefficiency? Addressing these questions, and undertaking this sort of specific analysis, should prove more effective than structuring additional supervision and demanding greater self-restraint. Agencies for this type of intervention are already in place.

The author's call for more sharing of information and increased communication poses problems as well. A "structured dialogue" might evolve into yet another government agency intent on regulating banks—a prospect that banks are hardly likely to encourage. Moreover, one wonders where it will stop. Should foreign policymakers become involved with every enterprise that bears on international relations? Is banking really that special? Agriculture, the energy industry, even universities may affect foreign policy today; should foreign policymakers not engage them in a dialogue, too?

Cohen should expect some disagreement over his policy recommendations and some resistance to his singling out of banks for special treatment. Yet it is to his credit that the book is provocative, for this quality indicates that Cohen has succeeded in his primary task. The careful reader is rewarded with an "understanding of the complex issues involved in bank-government relations in the foreign policy area"—so much so that he should feel qualified to disagree with the specifics of Cohen's recommendations. For the interested and patient reader, *In Whose Interest?* is a valuable resource and well worth the investment.

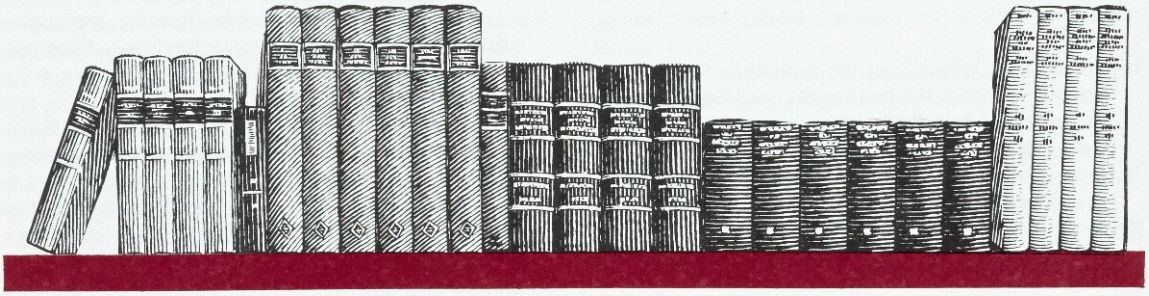
—Steven P. Feinstein

The reviewer, a specialist in stock and options markets, is an economist in the financial section of the Atlanta Fed's Research Department. *He wishes to express his appreciation to Sheila Tschinkel for her helpful comments and suggestions.*

Book Review

Reference Works in Business and Economics

Jerry J. Donovan



The books reviewed here are new and recently published monographs (1984-87) that have broad reference application in business and economics. Included also, however, are two rather specialized titles published by the International Monetary Fund, since these deal with concepts coming to the fore as the importance of international trade increases. Despite their proven excellence, continuing serial publications such as the annual *Economic Report of the President* do not fall within the scope of this review.

Accounting, Banking, Finance, and Economics

Barron's Finance and Investment Handbook, by John Downes and Jordan Elliot Goodman. Woodbury, New York: Barron's Educational Series, 1987. 994 pages. $18.95.

Designed as a desktop reference for investors of all kinds, this handbook seems sophisticated and comprehensive enough to suit the professional while being sufficiently basic and accessible for the student or occasional inquirer. The book focuses on the application of financial and investment information, and so its format incorporates a wealth of answers to timely questions. For instance, what do futures contracts for interest rates or for stock indexes involve? What are mortgage-backed (pass-through) securities and zero-coupon securities? A self-contained dictionary of finance and investment (pp. 159-541) covers these kinds of terms.

Exhaustive lists of agencies and other organizations useful to the investor make up another section of the book. Included, for example, is a hierarchical array of the Federal Reserve System with the addresses and telephone numbers for the Board, the District banks, and the Branch banks. Elsewhere, a useful selection of historical data and charts illustrates the performance of phenomena like the Bond Buyer Index, NASDAQ, and the Wilshire 5000 Equity Index. A thoroughly constructed table of contents and in-depth index permit ready access to points of inquiry. Recommended as a handy, compact reference book.

Dictionary of International Finance, by Julian Walmsley. Second edition. New York: John Wiley & Sons, 1985. 222 pages. $39.95.

This edition of a well-respected work emphasizes international topics and introduces

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The reviewer, associate librarian of the Atlanta Fed's research library, is a specialist in banking, economics, and finance information.

coverage of terminology related to growing areas like financial futures and options markets. Most entries consist of a concise definition or discussion of a term followed by a brief bibliography of further reference sources. Some definitions are accompanied by diagrams, as well.

"Balance of trade" is textually defined in American English terminology, but the French, U.K., and Continental idiomatic differences fundamental to understanding this concept are noted. "Futures" are discussed comprehensively not only in reference to commodities but also to financial instruments such as stock index futures. Additional terms of contemporary interest are "interest rate swaps" and "securitization." Names of foreign organizations appear in the original language with their respective acronyms: "Banco Centroamericano de Intergracion Economica" and BCIE. The "Bank for International Settlements (BIS)" entry exemplifies this dictionary's thorough scholarship: it refers the user to the Basle Agreement, for comparison, and to the European Monetary Fund, which the BIS administers. Recommended for research/scholarly use.

Handbook of United States Economic and Financial Indicators, by Frederick M. O'Hara, Jr. and Robert Stignano. Westport, Connecticut: Greenwood Press, 1985. 224 pages. $35.00.

Information about the most important U.S. measures of economic activity is uniquely compiled in this handbook. More than 200 indicators, drawn from 50 or more fully documented sources, are encompassed. Indicators may take many forms: volumes, ratios, indexes, composites, and so on, and they may be viewed over the short or the long term. The book is designed for use by researchers who need quick answers about various indicators, help in finding their current and historical values, and the names and addresses of their issuing agencies.

In addition to its inclusive treatment of serious economic indicators, the book also explains tongue-in-cheek "nonquantitative" measures (for example, the Hemline Index, Superbowl Predictor, and Drinking Couple Count) for the edification and delight of readers who must grapple with the often whimsical terminology of Wall Street. Besides the body of main entries, the work carries an alphabetical index and three appendixes (Nonquantitative Indicators, Abbreviations List and Guide to Sources, and List of Compilers of Indicators). Recommended for research/scholarly use.

The Desktop Encyclopedia of Corporate Finance and Accounting, by Charles J. Woelfel. Chicago: Probus Publishing, 1987. 518 pages. $27.50.

Beyond its authoritative definitions, this encyclopedia describes accounting and financial reporting theory, principles, and practices. It deals with conceptual foundations to provide a solid understanding of financial statements. Both a reference and a sourcebook, the work contains more than 270 short articles on accounting and finance, accompanied by some 2,500 entries for definitions of related concepts. The book was written with the cooperation of the Financial Accounting Standards Board, whose pronouncements are quoted throughout. The encyclopedia is alphabetized and indexed for easy access, and it offers over 75 exhibits to illustrate complex concepts. Readers who wish to explore topics further are assisted by extensive cross-referencing and bibliographies of primary and secondary sources.

Typical of the helpful discussions and information are the "Beta Coefficient" to assess market risk of stocks; the names of the current "Big 8" accounting partnerships; "Foreign Operations and Exchanges," which, for U.S. companies doing business abroad, describes the considerations regarding foreign currency transactions and the translation of financial statements denominated in a foreign currency; "Ratios," including such profitabilty measures as return on total assets and return on invested capital, with a three-page table spelling out kinds of financial statement ratios and interpreting their usefulness; and the concept of the "Value Added Statement" seen as the portion of the selling price of a commodity or service attributable to a stage of production. Recommended as a desk reference book, as well as for research/scholarly use.

Glossary of Financial Services Terminology. Chicago: The Institute of Financial Education, 1987. 85 pages. $4.95.

This terse but inclusive glossary speaks to the impact on vocabulary brought about by deregula-

tion, tax reform, and recently expanded menus of financial products and services. Offered by the Institute of Financial Education, a nationwide educational organization for personnel of savings and loan associations and cooperative banks, the book concisely defines the new vocabulary with the savings institution professional in mind.

The alphabetically arranged entries convey succinct working definitions of both old and new concepts. The reader can, for instance, find the terms ACH, ATM, ARM, and FPM; discussions of Chapters 7, 11, and 13 bankruptcies; junk bonds; and repurchase agreements ("repos"). Recommended for thrift institution executives and office personnel as well as for scholarly use.

Dictionary of Banking and Financial Services, by Jerry M. Rosenberg. Second edition. New York: John Wiley & Sons, 1985. 708 pages. $34.95.

The expansion and deregulation of the financial services industries have brought about enormous changes in the terminology used to describe their growth and their testing of regulatory boundaries. While some researchers may prefer F.L. Garcia's revision of Munn's *Encyclopedia of Banking and Finance* (eighth edition, 1983), this second edition of Rosenberg's *Dictionary of Banking and Finance* reflects in its different title, and in its substance, the vast changes that have occurred in financial services since the onset of deregulation.

The totally new work incorporates into its text, for instance, all the entries from the American Bankers Association's prodigious *Banking Terminology;* picks up abbreviations like EFT, ARM, ATM, and the venerable GIGO—for "garbage in, garbage out"; and scrutinizes the shades of meaning for terms such as "arbitrage," giving an equal nod to the spellings "arbitrager (arbitrageur)" to denote a practitioner. Alphabetically arranged and abundantly cross-referenced, the book is recommended for research/scholarly use.

Dictionary of Economics and Business, by S. E. Stiegler. Second edition. Aldershot, England, and Brookfield, Vermont: Gower Publishing, 1985. 462 pages. $35.50.

This rigorous dictionary of economics will facilitate the business person's search for a concise definition of economic terms, or of concepts from statistics, computing, government, and industrial relations where these fields overlap economics. As one would expect, some terms are specific to the United Kingdom. The dictionary handily defines terms like "lagged relationship" and discusses such economic concepts as the Edgeworth-Bowley box diagram (see Chart 1).

Working definitions are given for the E.C.U. (European Currency Unit), the E.E.C. (European Economic Community), and the E.M.A. (European Monetary Agreement), although, oddly, LIBOR (London Inter-Bank Offer Rate) is omitted. The GATT is taken up, as are Keynesian analysis and assorted current topics in the world of communication (for example, L.A.N., or local area network). Recommended for business people, particularly those doing business abroad, and for research/scholarly use.

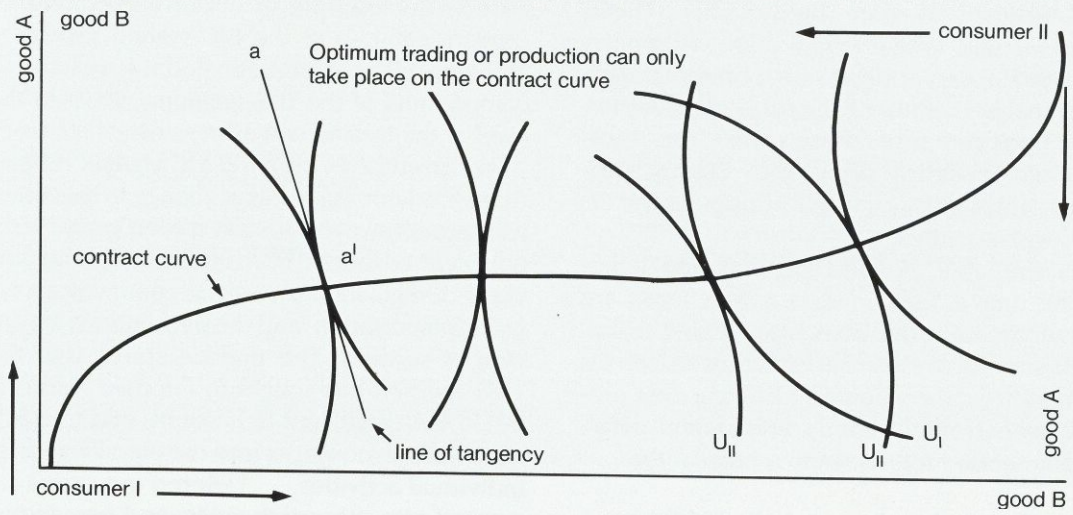
Dictionary of Economics and Financial Markets, by Alan Gilpin. Fifth edition. London: Butterworths, 1986. 245 pages. $42.95.

Beyond its utility in the area of economic definitions per se, this volume focuses on commodity, stock, financial, and futures markets for the benefit of students of applied economics and readers who wish to enhance their understanding of the financial press. An exposition of "futures contract," for example, includes the detailed elements of a typical futures transaction—information basic to understanding stock index futures as well as portfolio insurance, two phenomena receiving widespread attention since October 19, 1987 ("Black Monday").

In another vein, the author has enjoyed the cooperation of the Board of Governors of the Federal Reserve System in his detailed exposition of the nature and activities of the central bank of the United States. The entry illustrates the impact that open market operations and the regulation of deposits and loans have on spending, consumption, and investment, and, in turn, on the determinants of production, employment, and prices in the United States.

Within the volume's scope are LIBOR, to which interest rates on many variable-rate securities are tied, as well as short position, "stocks sold short and not covered as of a particular date." While much new material in this work relates to the United States, Canada, Aus-

Chart 1.
The Edgeworth-Bowley Box Diagram



Source: S.E. Stiegler, *Dictionary of Economics and Business,* 2nd edition (Aldershot, England, and Brookfield, Vermont: Gower Publishing, 1986), p. 124.

tralia, and the European Economic Community, the book remains heavily oriented toward the economics and finance of Britain. Recommended as a handy desk reference and for research/scholarly use, especially for those interested in business abroad.

Forecast and Historical Statistical Data

Key Indicators of County Growth, 1970-2010: Households, Income, Population, Employment. Washington, D.C.: NPA Data Services, 1987. 529 pages. $195.00.

This compendium of economic and demographic trends of the U.S. county economies includes historical and projected county (or equivalent) data for ten key indicators, including population, households, personal income, and employment. Each indicator typically is broken down into several facets; for example, employment subdivides into full- and part-time jobs as well as earnings per job. These data, presented systematically for four actual years and four forecast years, constitute the 1986 Regional Economic Projections Series (REPS) from NPA Data Services, Inc., an affiliate of the National Planning Association. Neither organization's forecasts are regarded as *official,* since the statistical methodology employed reflects the judgment of those private establishments. Nevertheless, the basic time series data on which their projections are based have been obtained from the Bureau of the Census and are official. Hence, the historical statistics exhibited in the tables can be accepted as official.

The series contain "consistent historical data for the period 1967-1986 . . . and projections for the years 1987-2010, for 52 economic indicators . . . and for 156 population series . . . and household indicators. The projection methods reflect the national and international as well as the regional and local economic growth trends, and the current demographic patterns of births, deaths, and regional population movements."

The volume opens with an overview of the geographic structure and growth of the U.S. county economies, illustrated by 12 maps showing county detail for the 48 contiguous states. The overview is followed by an analysis of structural features based on 1985 data, and then an analysis of growth trends with projected changes over the period 1987-2010. The data section, which comes next, presents the statistics in

tabular form, tagging them with appropriate FIPS (Federal Information Processing Standards) Codes to identify uniquely the geographical entities tabulated. Tables are arranged alphabetically by state, then county. (These tables are also available in a PC-ready version formatted for easy application in popular spreadsheet analysis software.) The concluding section of the book comprises three appendixes: metropolitan statistical areas with County FIPS Codes, states with County FIPS Codes, and state maps with counties.

Since reliable, detailed economic and demographic data at the county level frequently are difficult to locate, this book is a welcome arrival. Whether or not a researcher embraces its forecast methodology, the volume's historical data present an extremely handy and useful array. Recommended for research/scholarly use.

Main Economic Indicators: Historical Statistics, 1964-1983. Paris: Organisation for Economic Co-operation and Development, Department of Economics and Statistics, 1984. 656 pages. $35.00.

Most of the time series published in *Main Economic Indicators,* the OECD's monthly periodical, over the period 1964-83 are cumulated in this bilingual (English/French) reference work. For the organization's 25 member nations, the tables provide data on national accounts, industrial production, stocks and orders, construction activity, retail and wholesale trade, labor force, wages, prices, finance, foreign trade, and balance of payments. Recommended for research/scholarly use.

Statistical Data Definitions and Concepts

Standard Industrial Classification Manual, 1987. Washington, D.C.: Government Printing Office for the Office of Management and Budget, 1987. 703 pages. $24.00.

This is the first major revision of the standard industrial classification (SIC) scheme since 1972. The system was adopted by the federal government in 1941 to facilitate the collection and presentation of statistical data for manufacturing and nonmanufacturing industries. Since then, SIC codes have been used in the arrangement of all U.S. Census statistics on various industries. Additionally, the codes have been taken up by many nongovernment sources to organize data in market guides, directories of companies, and indexes (for example, in all Dun and Bradstreet directories). Use of the SIC system promotes comparability of statistical data describing components of the U.S. economy down to the level of the individual business establishment.

As currently revised, the *SIC Manual* reflects three fundamental areas of change in the American economy over the last fifteen years: technological advances in manufacturing and services; deregulation of banking, communications, and transportation; and the tremendous expansion of services. The preface states that the 1987 revision has sought to improve "industry detail, coverage, and definitions, and to clarify classification concepts and the classification of individual activities. . . . Deleted industries are merged into other industries, and new industries are created by subdividing or restructuring existing industries. Various industries have also been changed by transfers of individual activities, primarily to increase the accuracy, consistency, and usefulness of the classifications." This fine-tuning is apparent in the revised codes for "Computer and Data Processing Services" (see Chart 2).

An appendix is devoted to two-way conversion tables for codes from 1972 and 1987. Principles and procedures for the review of the Standard Industrial Classification constitute a second appendix, and the third is a glossary of abbreviations.

Aside from being indispensable for anyone involved in tabulating or interpretating U.S. industry statistics, the 1987 SIC Manual is an important tool for capturing the impact of the basic shifts that have occurred in the domestic economy since 1972.

IMF Glossary; English-French-Spanish, 1986. Washington, D.C.: International Monetary Fund, 1986. 286 pages. $15.00.

While this authoritative work is entitled a "glossary," it is more in the nature of a polyglot thesaurus or dictionary of synonyms, since it does not define the terms which it systematically lists in English, French, and Spanish. The substance of the book is the International Monetary Fund's controlled vocabulary, that is, the words,

Chart 2.
Expanded Classification for "Computer and Data Processing Services," SIC Manual, 1972 vs. 1987

1972		1987	
737	**Computer and Data Processing Services**	737	**Computer and Data Processing Services**
7372	Computer programming and other software services	7371	Computer programming services
7374	Data processing services	7372	Prepackaged software
7379	Computer related services, not elsewhere classified	7373	Computer integrated systems design
		7374	Data processing and preparation
		7375	Information retrieval services
		7376	Computer facilities management
		7377	Computer rental and leasing
		7378	Computer maintenance and repair
		7379	Computer related services, nec

Source: *Standard Industrial Classification Manual, 1972* (Washington, D.C.: Government Printing Office for the Office of Management and Budget, 1972), p. 601; and ibid. (1987), p. 440.

Chart 3.
"Balance of Payments" Example from IMF Glossary

B-12	balance of payments assistance	aide au titre de la balance des paiements concours (financiers) au titre de la balance des paiements	asistencia con fines de balanza de pagos
B-13	Balance of Payments Division [IMF-STA]	Division de la balance des paiements	División de Balanza de Pagos
B-14	*Balance of Payments Manual* [IMF]	*Manuel de la balance des paiements*	*Manuel de Balanza de Pagos*
B-15	balance of payments need	besoin resultant (de la situation) de la balance des paiements	necesidad de balanza de pagos
B-16	balance of payments position	position de balance des paiements situation des paiements exterieurs solde de paiements exterieurs [*parfois*]	posición de balanza de pagos situación de balanza de pagos saldo de la balanza de pagos [*a veces*]
B-17	balance of payments test [SDR]	critère-test de la situation de la balance des paiements	prueba de la situación de la balanza de pagos
B-18	balance of trade trade balance	balance commerciale	balanza comercial

Source: *IMF Glossary,* 1986 (Washington, D.C.: International Monetary Fund, 1986), p. 13.

phrases, and institutional titles most commonly encountered in IMF documents about money and banking, public finance, balance of payments, and economic growth. The English terms, with French and Spanish equivalents, are arranged alphabetically in the first section of the book and are frequently cross-referenced to codes denoting their source, subject field, or country (see Chart 3).

Sections permitting alphabetical access by French and by Spanish follow, along with a section that lists abbreviations and acronyms in alphabetical order, regardless of language. Of particular interest to persons concerned with foreign currencies is the last section of the book, which specifies currency units for all 141 member nations of the IMF.

While this book is primarily intended as an aid for IMF language personnel, it clearly will be useful to many researchers in banking, finance, and economics whose work deals with areas of the world where English, French, or Spanish is

Chart 4.

Descriptor	**VOCATIONAL TRAINING**	
Language equivalents	**FORMATION PROFESSIONNELLE/ FORMACION PROFESIONAL—06.03.07**	**Facet**
Scope note	*ACTIVITIES AIMED AT PROVIDING THE SKILLS, KNOWLEDGE, AND ATTITUDES REQUIRED FOR EMPLOYMENT IN A PARTICUALR OCCUPATION (OR A GROUP OF RELATED OCCUPATIONS).*	
Synonym (used for)	*UF:* *OCCUPATIONAL TRAINING*	
	TT: TRAINING	**Top term**
Broader term	*BT:* TRAINING	
	NT: AGRICULTURAL TRAINING	**Narrower terms**
	APPRENTICESHIP	
	BASIC TRAINING	
	FURTHER TRAINING	
	IN-SERVICE TRAINING	
	INDUSTRIAL TRAINING	
	MODULAR TRAINING	
	PERSONNEL TRAINING	
	PREVOCATIONAL TRAINING	
	RETRAINING	
	SANDWICH TRAINING	
Related terms	*RT:* APPRENTICES	
	OCCUPATIONS	
	TRAINEES	
	TRAINING ALLOWANCES	
	TRAINING CENTRES	
	VOCATIONAL EDUCATION	
Synonym	*OCCUPATIONAL TRAINING*	
Descriptor	USE: VOCATIONAL TRAINING—06.03.07	**Facet**

Source: *Macrothesaurus for Information Processing in the Field of Economic and Social Development* (New York: United Nations, 1985), p. xiv.

spoken or who are making subject presentations there.

Macrothesaurus for Information Processing in the Field of Economic and Social Development, prepared by Jean Viet. New York: United Nations, 1985. 347 pages. $35.00.

The introduction to this thesaurus states that it forms a "common tool for indexing, processing and retrieving of information contained in documents issued by diverse specialized agencies, principally those of the United Nations system, and thereby promotes the mutual exchange of data." The book is divided into four parts: (1) an alphabetical list of terms in English, accompanied by their French and Spanish equivalents; (2) a display of subject headings, or "descriptor groups," arranged by subject code number; (3) a hierarchical index which presents chains of descriptors that can be traced in the thesaurus from broader terms, or "Top Terms" (TT), down to the most specific terms; and (4) the key-word-out-of-context index, wherein all significant words used to make up the descriptors are arranged in alphabetical order (see Chart 4). The first three hierarchical sections are particularly useful for determining precise components of the concepts employed in U.N. documents on economics and social development. This revised edition strives for compatibility with other U.N. sectoral thesauruses serving agriculture, industry, labor, education, population, science, technology, culture, communication, health, and the environment. Recommended for research/scholarly use.

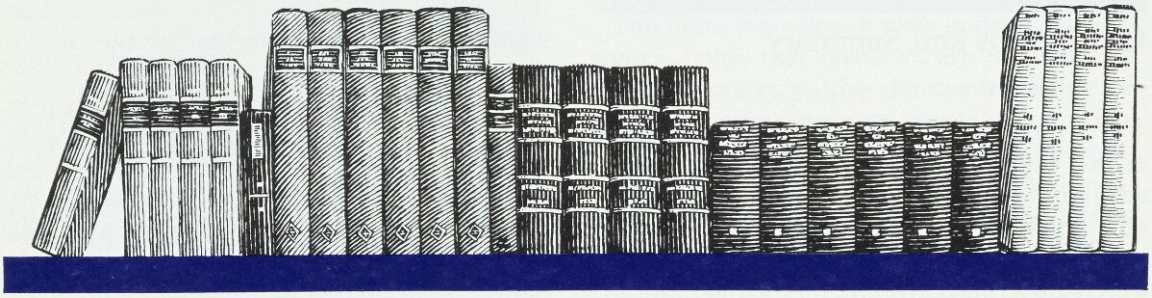
A Manual on Government Finance Statistics. Washington, D.C.: International Monetary Fund, 1986. 373 pages. $10.00.

The focus of this manual is on national government financial transactions—taxing, borrowing, spending, and lending. It relates these, in a definitional sense, to other data available for an economy, to wit, sets of national accounts and national accounting report systems. Emphasis is placed on how to summarize and organize government financial statistics in formats appropriate for analysis, planning, and policy determination. The volume features a glossary, along with in-depth indexing. Helpful in understanding the theoretical underpinnings of government finance reporting, the manual is recommended for research/scholarly use.

Book Review

Leadership at the Fed

by Donald F. Kettl
New Haven: Yale University Press, 1986.
218 pages. $22.50.



Donald Kettl writes that this is "a story of the Fed's power and independence told through the history of the Fed's chairmen." More precisely, *Leadership at the Fed* looks at the exercise of power in one facet of the Federal Reserve System's activities—the formulation of monetary policy—from the perspective of the chairmen's relationships with Congress and the administration. In the eyes of the author, these relationships display the basis of the Fed's power, which, in his opinion, resides in the person of its chairman. He concludes that, rather than being independent, the Fed is interdependent with the president, not only because of the obvious political impact economic issues carry but also owing to what he views as the increasing entanglement of monetary and fiscal policy over time. Kettl pursues his theses through a chronological narrative to which he appends a typology of interaction between the chairmen, on one hand, and the various presidents and Congresses, on the other.

Two themes underlie the narrative. The first, "the struggle for independence from the Treasury," occupies the period from passage of the Federal Reserve Act in 1913 to the Fed-Treasury accord of 1952. This agreement freed the Fed from its obligations to support Treasury security offerings at artificially low, "pegged" rates of interest and allowed monetary policy to be conducted at the Fed's discretion. The second, related theme is the ambiguous one of the Fed's accountability in light of its post-accord monetary policy discretion. The theme appears in the search for an acceptable method for communicating the intention of monetary policy to congressional representatives and presidents, who, Kettl notes, tended to have the layman's understanding of economic concepts and the politician's passion for easy money.

Kettl gives short shrift to the System's first two decades, which span the tenures of seven Fed governors, as the chiefs of the Fed were known prior to 1935. During that early period, the secretary of the Treasury, along with the comptroller of the currency, had a seat on the Fed Board and, according to Kettl, effectively headed up the Fed. If there is a basis for this opinion, it is not consistently presented. In fact, the author seemingly contradicts himself by his treatment of events in the 1920s. Kettl opines that the Fed leadership was "immobilized" at that time by the necessity of supporting the Treasury's financing of the First World War. Nonetheless, when he narrates the Fed's ensuing post-armistice "mistakes"—moving too slowly in early 1920 to boost interest rates in the face of inflation and then again too slowly to decrease rates in 1921 as the economy sharply declined—the Treasury's guiding hand is either invisible or

absent. Kettl provides only fleeting glimpses of the thought process within the Fed's leadership to support his belief that "neither the Fed nor anyone else understood the dynamics of inflation and recession." The same neglect of connective tissue holds for the apparent abdication of power in the mid-1920s by successive governors Daniel Crissinger and Roy Young to Benjamin Strong, head of the New York Fed, whom the author credits with the "discovery of economic management" during the recession of 1923. Having been conditioned by this point to regard the Treasury as running the Fed, the reader is left to wonder whether the Treasury secretary, too, surrendered authority to Strong during this interlude.

Kettl's real interest in Fed leadership begins with Marriner Eccles, the first leader to hold the title "chairman." Eccles's personality and leadership style are treated with considerably more depth than those of his predecessors, as are the details of his relationship to President Franklin Roosevelt. Although Eccles lacked formal training in economics, he had creative ideas regarding economic policy and bank regulation. Under his guidance, the Federal Open Market Committee (FOMC) became prominent in the conduct of monetary policy and the Fed gained political independence. The latter was achieved through the departure of the treasurer and comptroller from the Board of Governors under the terms of the Banking Act of 1935.

However, Kettl contends that these accomplishments were implemented at first more through the political acumen of Roosevelt than through the efforts of Eccles, who was hampered by his want of political finesse. Moreover, while the reforms associated with Eccles led on the one hand to greater independence from the Treasury Department, on the other hand they resulted in closer coordination between the Fed's monetary policy and the administration's fiscal policy than at any previous point in the System's history. This linkage occurred, Kettl writes, both because centralizing open market operations in Washington had removed individual discretion from the Reserve Banks and because Eccles—"a Keynesian who had never heard of Keynes"—was so closely aligned with Roosevelt's ideology.

Eccles becomes Kettl's prototype for a threefold categorization of Fed chairmen in their relationship with their chief "constituent," the president. Only Eccles and William McChesney Martin fall into all three classes—accommodation, confrontation, and transformation. The author notes that "despite the vast quantity of writing about the Fed's independence, the most notable fact about the Fed is that only rarely have the president and the chairmen been far out of step." During 37 of the 52 years between 1934 and 1985—or "71 percent of the time" in Kettl's rather overexact computation—chairmen have tended to accommodate the president. "The job of the chairman during these years fundamentally was seeking to meet the presidents' overall economic goals," he writes. For example, during the New Deal and World War II, Chairman Eccles "enthusiastically delivered the policies that Roosevelt wanted."

In only six years of the survey period were chairmen in confrontation with presidents by Kettl's standards. These occurred during the peg controversies of 1945-48 and 1949-51 and the Lyndon Johnson-Chairman Martin dispute of 1965-66. In each of these cases, war put heavy demands on the economy, and Presidents Truman and Johnson pressured chairmen to keep interest rates low at times when the Fed was concerned about arresting inflation. Among the nine years of transformation, which is his third category, Kettl includes 1934-35, the period around passage of the Banking Act; 1951-56, when Martin practiced his strategy of "leaning against the wind;" and Paul Volcker's "experiment with monetarism" in 1979-82. During these years, the author believes Fed chairmen moved to alter the basic relationship with the president.

Eccles is said to have pioneered the transformation mode during negotiations over the Banking Act of 1935, even though he is mostly characterized as having been accommodative to Roosevelt. There were confrontations during this period as well. As Kettl points out, Eccles particularly sparred with Roosevelt's Treasury secretary, Henry Morgenthau, who in 1936 established his own vehicle for conducting open market operations by selling 90-day Treasury bills and using the proceeds to buy and hold gold. Through this effort to hold rates steady, which was christened a "sterilization" plan, the secretary hoped to soak up the gold that was flowing into America and threatening to put upward pressure on interest rates. In doing this,

Morgenthau side-stepped Eccles's effort to tighten monetary policy by raising reserve requirements. Although the Treasury chief's action received the president's support, Kettl still sets Eccles within the basic pattern of accommodation vis-a-vis Roosevelt. As Eccles's period of confrontation, he points to the 1945-48 controversy over the Treasury peg—a conflict identified with the Truman administration. Eccles's protracted postwar campaign against pegging so rankled Truman that the latter refused to reappoint Eccles to the chairmanship.

With Kettl's analysis of Eccles, one encounters a conceptual problem that haunts his characterization of succeeding chairmen. If we are to accept Kettl's periodization, we are forced to agree that in times of "accommodation" the chairman's actions are guided by his sense of what the president desires, or at least by the weight of the president's power brought to bear on a given situation, rather than by a parallel reading of what steps are necessary to achieve economic goals. The fact that there are identifiable periods of confrontation during the half-century Kettl reviews would seem to suggest, however, that while monetary and fiscal policymakers tended to agree on the economy's needs, at times their interests distinctly diverged because of the nature of their responsibilities. At such moments of stress, notably during wartime, presidents no doubt understood the Fed's rationale on some level but had a broader set of policy mandates to weigh. By the same token, during those longer "accommodative" spans, Fed chairmen may simply have been reacting to the same economic data in the same way as the presidents, rather than bowing to the chiefs of state. Kettl would have to present more overt proof of conscious accommodation to be convincing.

Kettl next turns to Thomas McCabe, Eccles's successor, whom he classes as a weak leader very much in Eccles's shadow. Despite his loss of the chairmanship, Eccles remained on the Board, as did a number of Board members whose candidacy he had supported. McCabe was thus alone and without support for his strategy of acting as a mediator in the effort "to transform the Fed's decade-old ties with the Treasury by backing away from the peg as gradually as possible." Although this approach was "a complete failure," Kettl characterizes the McCabe chairmanship as one in which the Fed pursued the very independent and controversial course of maintaining restrictive monetary policy to combat double-digit inflation despite the Treasury's demands for low interest rates to finance the Korean War. Leadership was being exercised at the Fed, but we are left to wonder by whom. One might have learned more about the tenor of internal Fed politics had Kettl carefully analyzed the voting on Board decisions or offered fuller disclosures from his store of anecdotal information.

The peg conflict of 1949-51 resulted in the accord hammered out between Treasury and Fed officials and McCabe's resignation shortly afterwards, an event that led some observers to speculate this was part of the deal. The author does not resolve the question. McCabe was replaced by William McChesney Martin, who had represented the Treasury in working out the accord. Unlike McCabe, Martin was able to transform the Fed through a strategy he called "leaning against the wind"—using the Fed's monetary policy tools to set policies counter to economic disturbances. From the mid-Eisenhower era in 1956 through 1965, Kettl sees Martin as accommodative. Eisenhower made it clear that he supported Fed independence, while Martin for his part participated in regular conversations with officials from the Council of Economic Advisors and the Treasury—particularly in a foursome called the "Quadriad"—to discuss policy options.

"The fact that there are identifiable periods of confrontation . . . would seem to suggest . . . that while monetary and fiscal policymakers tended to agree on the economy's needs, at times their interests distinctly diverged because of the nature of their responsibilities."

In the Kennedy administration, this arrangement led to what Kettl presents as a cooperative venture called "operation twist." At the Administration's behest, the Fed shifted its attention to long bonds from short-term securities like Treasury bills in order to stimulate long-term

investment. The idea behind the "twist" was to keep long-term interest rates low by artificially increasing demand for bonds. Economists tend to doubt that such a policy can effectively hold long-term rates lower than they would otherwise be, and Kettl leaves the issue without assessing whether the "twist" actually worked. It is noteworthy that all the author's supporting sources for his argument that Martin buckled under to the Administration's plan are taken from administration papers, particularly those of Walter Heller. Martin, Kettl tells us, studiously avoided officially endorsing the plan and "simply presented changes in the Fed's buying habits as shifts in operating policy rather than explicit coordination with the Administration." Again, evidence of accommodation on the chairman's part is largely circumstantial.

"(From a) correlation between the number of bills introduced per year and the level of interest rates . . . (Kettl) concludes that Congress's interest in the Fed tends to increase with interest rates."

Cooperation turned to confrontation in the Johnson administration, however, as the Fed under Martin allowed upward pressure on interest rates in the face of the Vietnam War. Nonetheless, because Martin had been able to accommodate most presidential policies while nurturing the public image of independence, he could "establish the institutional base for ongoing cooperation with the president in a way that did not diminish (and even enhanced) the Fed's power." This legacy has lasted to the present, in the author's opinion.

Arthur Burns is clearly the Fed leader the author most enjoyed writing about. Burns belongs to Kettl's camp of "accommodative" chairmen, with the qualification "but often in confrontational style." Indeed, his confrontations with Richard Nixon make for some of the most entertaining passages in the book. For the period of Burns's leadership, Kettl begins to concentrate on his second theme—the Fed's accountability for monetary policy. This issue arose once the Fed alone became responsible for its actions in the wake of the 1952 accord granting it independence from the Treasury. The will of Congress to impose some controls on the Fed mounted during Burns's chairmanship. The preceding two decades had been relatively quiet, except for occasional attacks from the likes of Congressman Wright Patman, who believed that the Fed was "a secret club operated for the benefit of bankers," in Kettl's words. This opposition had come from such extreme quarters that the Fed was able to defuse it, but such was not the case under Burns. In part, Kettl attempts to explain this growth in congressional interest by a graphic correlation between the number of bills introduced per year and the level of interest rates—a measure of his own invention. From this measure he concludes that Congress's interest in the Fed tends to increase with interest rates. Since interest rates rose appreciably from the late sixties through to the eighties, Kettl sees a gathering storm of protest which generated a spate of bills demanding greater accountability from the Fed.

It fell to Burns to battle Congress over the accountability issue, and Kettl suggests it was a task the chairman relished. As the anecdote describing Burns's preparation for a congressional hearing by shadow boxing suggests, his relationship with the legislative branch was anything but accommodative. The Fed fought and won a continuing battle led by Patman and others to force immediate disclosure of monetary policy deliberations and pulled out all the stops to lobby unsuccessfully against a bill authorizing audits of the Fed by the Government Accounting Office. Senator Henry Reuss spearheaded a concerted congressional effort to force the Fed to publish monetary targets once he adopted the monetarist doctrine that central bank policy should be guided by a rule. (The Fed had rejected this monetarist approach from the time that it first was urged in the 1930s.) The senator's concept was to set explicit interest rate targets for the Fed and establish a deadline for meeting them, thereby limiting the Fed's discretion. Kettl writes that Burns believed no single economic measure, interest rates in particular, was "adequate to describe

the condition of money and credit." He successfully negotiated to let the Fed establish a range for a measure of his own preference—monetary aggregates like M1 and M2. In 1978, reporting of those monetary targets was formalized by the Humphrey-Hawkins provision calling for twice-yearly reports to Congress that would explain the Fed's goals vis-a-vis the administration's fiscal program. Kettl regards Burns's choice of indicators as providing vehicles of accountability that were vague enough to preserve the Fed's flexibility and "blunt the most threatening congressional tactics." He describes M1, M2, and so forth as "shields" and "technical jargon . . . that befuddled most members of Congress."

After a brief period in which Fed Chairman William Miller is shown to have failed both in his attempts to deal with inflation and "impose a corporate model on a collegial board," Kettl tells us the "shield of flexibility" was wielded with renewed skills by Paul Volcker. Because of his experiment with monetarism in the battle against inflationary forces, Volcker's chairmanship wins a listing under the rubric of "transformation." Volcker accomplished a transformation in the Fed's relations with the administration by using "the theoretical weapons of the Fed's sharpest critics as a shield behind which to increase interest rates, and when congressional attack made continued tight money politically impossible, he skillfully backed away from the monetarist prescription while leaving everyone uncertain about just what he had done." That is, by focusing attention on control of the money supply as a tool for defeating the inflation mentality into which the nation had fallen—a tactic that was abandoned, according to Kettl, in favor of a more blatantly discretionary approach when M1 ceased to behave in proper monetarist fashion—Volcker was able to give monetary policy unprecedented prominence in the political arena.

Despite the author's assertion that "congressional attack" caused the Fed to back away from its tight money strategy, he writes elsewhere that "FOMC members had decided that continuing to follow the M1 targets would produce interest rates that were too high and economic growth that was too slow." Kettl offers a reconstruction of the FOMC's thought process that points less to political pressures for changing course than to concern over the distorting effect of the newly introduced negotiable order of withdrawal (NOW) accounts on M1. When interest rates descended in early 1982, people began using these interest-bearing transactions accounts as much for savings as check-writing purposes, which rendered NOW accounts less liquid forms of money and, hence, less what M1 was designed to measure. Late in that year, Volcker announced that the Fed would de-emphasize M1 and focus on M2 and M3, a move that Kettl says allowed the Fed to ease money without appearing to back away from its war on inflation. Even though his intention is to show the Fed deferring to Congress, the information Kettl presents supports an equally plausible case for easing as the most prudent decision given current economic conditions. As with Eccles's "accommodation," a careful reader must question whether politics or economics was the underlying dynamic in the Fed's actions.

"Even though his intention is to show the Fed deferring to Congress, the information Kettl presents supports an equally plausible case for easing as the most prudent decision given current economic conditions."

The author concludes by discussing the Fed's various constituencies and rationalizing his choice of the president as the Fed's chief constituent. As noted at the outset, he sees the Fed's independence as a function of the chairman's relationship with presidents, who are viewed as more (Truman and Nixon, for example) or less (Eisenhower and Reagan) concerned with the Fed's activities. The chief executives' constituent role has grown more pronounced over time because, Kettl believes, they have become increasingly dependent on monetary policy. By the late 1960s the budgetary process had become inflexible to the point that later administrations have been forced to fall back upon the Fed's influence over the supply of

money and bank credit to fulfill their campaign promises to boost employment and economic growth. In addition, the internationalization of economic issues, specifically the debt of less-developed countries and the U.S. trade deficit in the 1980s, made Fed actions of key significance to the administration's efforts in international relations.

With his issues of the Fed's power base and its independence thus decided to his apparent satisfaction, Kettl turns to summarizing the accountability question: "Is the Fed—as a powerful, legally independent agency—accountable?" He delivers no final answer, stating instead that "real accountability for economic policy has become hidden increasingly in a subterranean system in which elected officials can remove their fingerprints from politically dangerous policies they implicitly support." Kettl is closest to responding to his rhetorical question when discussing the Fed's decision to ease monetary policy in late 1982. At the same time, it abandoned M1 as an intermediate target in favor of broader monetary aggregates. He describes Volcker's November 1982 (the text misprints 1979) testimony to the Joint Economic Committee as a "masterpiece of Fedspeak. . . . The ambiguity of Volcker's remarks quite intentionally left his listeners uncertain about what the Fed would do next. The message of easier money and lower interest rates, however, was unmistakable."

"Overall, Leadership at the Fed has two major weaknesses. One is . . . that the work becomes for the most part one-dimensional. The second is the author's inability to come to grips with the issue of the Fed's accountability. . . ."

Whether the chairman's intention was in fact to create uncertainty, the example helps to define the root problem of accountability, that is, the difficulty of attaining consensus on how the goals expressed in the often abstract vocabulary of macropolicy should be achieved. As Kettl intimates, at the macro level everyone—congressmen, presidents, and Fed chairmen alike—agrees on the ultimate policy outcomes of gross national product (GNP) growth accompanied by low levels of unemployment and inflation. The challenge is to reach agreement upon the tradeoffs that efforts to attain those goals entail. Inflation can be lessened, but it might cost an economic slowdown and higher unemployment; the budget deficit can be cut, but only at the expense of higher taxes or reduced services. In this environment, *all* policymakers hesitate to specify how they propose to capture their goals, either for fear of voter dissatisfaction on the part of elected officials or in the interest of avoiding market disruptions on the Fed's part. Given these restraints, it is somewhat misleading to concentrate as Kettl does on "Fedspeak," with its implication of deliberate disinformation, unless a comparable exploration of the verbal maneuverings resorted to by congressmen and administration officials is offered.

Overall, *Leadership at the Fed* has two major weaknesses. One is a focus so narrow—confined to the Fed's monetary policy prerogatives and the chairman's part in effecting them—that the work becomes for the most part one-dimensional. The second is the author's inability to come to grips with the issue of the Fed's accountability, ostensibly the book's underlying purpose. Kettl's restricted scope brings selected events to the fore without providing sharp contrasts against which to view them. In particular, the historical context is a casualty. With the struggle for release from Treasury domination as one of his main themes, for example, the author could offer background by explaining that the Treasury in effect served as central bank before the Fed was established. Aside from overseeing the national banking system, the issuance of currency, and international flows of gold, Treasury officials occasionally conducted open market operations very much like those the Fed would later carry out. Lacking this knowledge, a reader who learns that during World War I "some shrewd Fed officials realized that buying or selling government securities as part of the Treasury's support program could also help speed up or slow down the economy" would erroneously infer that no precedent

existed for this crucial tactic of monetary policy.

Kettl's book is further marred by a lack of supporting detail for events parallel in time to his recounting of the chairmen's actions. In the story of the Fed's early days we are given the feeling, quite correctly, that international gold flows had considerable impact on the domestic economy. Much is made, for example, of Benjamin Strong's 1927 discussions with Montagu Norman of the Bank of England on Europe's gold drain. However, we are not apprised of the abandonment of the gold standard by many countries and the concurrent nationalization of gold in the United States in the 1930s, nor of the Bretton Woods agreement, which established a system of pegged exchange rates after World War II, nor even of the move to floating exchange rates during the Nixon administration in 1972. The latter, in particular, has had major implications for monetary policy in this decade and added a new constituency—the world outside our borders, no less—to the Fed's list.

One-dimensionality also distorts the picture of the Fed and its operations that emerges from the text. Monetary policy formation is but one of the Fed's powers, and it is supported by the mandate to supervise and regulate the commercial banking industry. The importance of that aspect of Federal Reserve workings was demonstrated in the events leading to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA 80), which required the Fed to price services competitively and deal with a host of fundamental institutional changes. Working out the details of the legislation required leadership and political skills of similar subtlety to those demanded in the formation of monetary policy. Furthermore, adjusting to the bill's effects, particularly the mandate to price services that had formerly been provided free to member institutions and thereby to enter the competitive market for those services, has changed the entire fabric of the System. Astonishingly, DIDMCA 80 is not discussed in Kettl's book. The reader is forced to ask whether this omission, along with the general neglect of the Board's relations with the banking industry, occurs because it complicates Kettl's simplistic view of the chairman as the Fed's sole leader of importance. Whatever the reason, flaws such as these seriously impair Kettl's credibility, further weakening already suspect conclusions.

Concentration on so narrow a band of information would not be deleterious if it led to attainment of the researcher's objectives, in this case an understanding of the Fed's independence and accountability. As already noted, however, Kettl leaves accountability "hidden . . . in a subterranean system." Perhaps he would have done better to look more thoroughly outside the boundaries formed by his basic premise. Because of the weight he assigns to actions of chairmen and presidents, Kettl tends to seek out the drama of interpersonal struggle over the reality of institutions confronting the impersonal forces of the macroeconomy. A more balanced approach would be to argue that, in terms of monetary policy, the Fed's accountability is to the economy itself, to all the people who participate in it, and to the capital markets, rather than to the few in government circles whose opinions are most visible. The economic indicators—gross national product, unemployment, inflation, dollar exchange rates—are the standards by which monetary policy is judged daily in the markets, which will not long brook overly expansive or restrictive actions without equal and opposite reactions. If a given chairman appears accommodative or confrontational vis-a-vis the president, it is likely because the FOMC's united judgment of the direction in which the numbers seem to be moving agrees or disagrees at best with the assessment of that administration's economists, at worst with the self-serving requirements of politicians facing election.

It was, of course, to distance the Fed from political considerations in policy formation that its structure has been shaped as it is by legislation over the years. From Alexander Hamilton to the present, political leaders and theorists have recognized the inherent conflict of interest in government control of both monetary and fiscal policy. As frustrating as the Fed's independence may at times be to legislators, it is probably in accord with this conflict-of-interest belief that Congress—which created the Federal Reserve System in the first place—has consistently backed away from forcing clearly defined standards of accountability on the Fed. Given this aversion, addressing the question of power and independence that Kettl sets out to explore is beset with

extreme difficulties. Independence, it would seem, is inversely related to accountability, and the legislative branch has chosen for the most part to maintain the Fed's latitude. By assuming that the Fed's independence is a function of the chairman's relationship with the president, Kettl implicitly throws much of the Fed's accountability to the executive branch as well, where it belongs neither in the Fed's design nor in practice. Thus, while applauding Kettl's effort to bring the perspective of political science to bear on issues of great importance, one must also conclude that the most critical questions he raises remain unanswered, awaiting a more penetrating examination.

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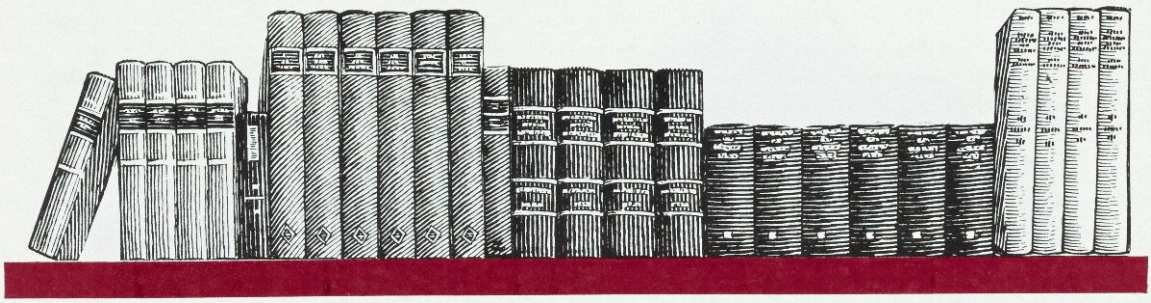
Book Review

Hot Money and the Politics of Debt

by R. T. Naylor
New York: Simon and Schuster, 1987.
463 pages. $18.95.



Recent events in Central and South America are directing ever more attention to the large amount of underground economic activity occurring in "problem" debtor nations. Such countries must devote a sizable portion—perhaps all—of their foreign exchange earnings to debt service. They also need to purchase foreign capital goods to further their development process. Yet they simply do not have a sufficient legitimate trade surplus to meet both needs. Exacerbating the problem may be capital flight, as domestic residents seek to invest abroad in search of a higher or safer rate of return.

At the same time, however, some of these countries are the source of billions of dollars worth of illegal drugs exported to the United States. Obviously, if their drug-generated foreign exchange earnings, combined with fleeing domestic capital, could help ease the external debt burden of these nations, their debt problem would be substantially reduced.

R.T. Naylor's *Hot Money and the Politics of Debt* purports to explore the link between illegally acquired or laundered money and the debt crisis in many developing countries. *Hot Money* consists of seven parts with a total of twenty-two chapters, each ingeniously titled. (Chapter one, for example, is headed "Capital Flight in the Jet Age.") The first six parts treat various events revolving around the "hot money" theme, while the final part focuses on problem debtor countries. The text is written in a breezy style; a wealth of thoroughly indexed facts and sequences of events is set forth in considerable detail. Unfortunately, there is little by way of analysis.

The notion of drug exports paying off loans to industrialized economies holds a certain titillation; conceptually, it accommodates all sorts of legally and morally reprehensible goings-on. Unquestionably, the book's title is meant as a teaser of just such ideas. Imagine an unveiling of how money-center banks profit from illicit activities, perhaps even applying political pressure to see that these efforts continue unfettered. Indeed, the book might be the sort of exposé that results in fundamental reforms or felling of the high and mighty and unprincipled.

Unfortunately, *Hot Money* fails to deliver on any such promise. The prose embodies far too little substantive analysis and far too much anecdote and innuendo to convey a real understanding of the problems of hot money or debt, much less of their potential interrelation.

Much to the detriment of his work, Naylor gives the reader scant framework for com-

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This book review is based on the reviewer's earlier comments in The Bankers Magazine *(January/February 1988).*

prehending the world of nefarious international transactions. Thus, before considering the substance of his enticingly titled book, it is useful to devise a taxonomy for "hot money." Generally, three rather different types of hot money, distinguished by their motivation, suggest themselves.

The first type of hot money is simple capital flight. For whatever reason, wealthy individuals might no longer wish to hold their wealth in a particular country, and so they move it elsewhere. Because local authorities usually try to erect legal barriers to capital flight, such a transfer may violate some exchange control laws. Otherwise, however, the capital originates legally, and it leaves the country essentially owing to economic considerations. In principle, this hot money movement does not differ from any other international capital flow, except that once beyond the exchange controls the capital, or its return, is unlikely ever to be repatriated.

Seemingly, the problem of capital flight is most acute in precisely those economies where it creates the greatest turmoil. Heavily indebted Third World countries need whatever domestic capital and hard currency they can secure. Of course, capital flight deprives them of both.

The second type of hot money is currency that requires laundering. When the operators of an illegal enterprise want to spend their profits domestically, they need to remove the taint of crime so that these ill-gotten gains look legitimate. A simple example of laundered funds which begins *Hot Money* is that of the unlawful profits sent abroad by Meyer Lansky to a bank that lent these same funds back to him. Not only could Lansky then use this laundered money as he would the proceeds of a legitimate loan, but he also could deduct from his taxes whatever interest he paid to himself through the foreign bank.

Despite its illegality, money laundering results in a net benefit to the originating nation. While the ruse usually entails some foreign financial agent, whatever money is laundered ultimately stays in its home country, where it moves aboveground into the legitimate, and taxed, portion of the economy.

The final type of hot money comes from purely underground capital movements. Since these illegally generated funds never surface in the domestic economy, they cannot really "flee," though their movements may otherwise closely resemble capital flight. Examples abound in part three of *Hot Money*, "High Finance in Cocaine Country," which focuses on the pelf cocaine barons channel into investments outside the Andean countries. As is often the case when countries suffer from aboveground capital flight, these nations could use some of this hard currency to service their external debt. The problem is that once the authorities find the money's source, which is illegal domestic activity, they have some obligation to "kill the goose that lays the golden egg." The alternative of legalizing the drug production industry to get to its cash is something the United States has strongly discouraged.

To sum: in the eyes of the receiving country capital flight and underground capital movements may appear very similar—with the exception of the account holder's moral character. Both types of hot money wield much the same effect on the economy of the originating nation, but only in the standard capital flight case does the government ever have any access to or firm knowledge of the capital. Finally, money laundering just moves capital up from the subterranean to the aboveground portion of one country's economy. In so doing, however, it may be forced to employ the international facilities used by other forms of hot money.

Naylor's book offers no intellectual grounding like this typology, either for its discussion of hot money or of the politics of international debt. Instead, the reader is left with a bare, though sometimes amusing, set of anecdotes. The text relates the course of events rather well, yet it is bereft of any explanation that would promote understanding of why things happened as they did. How is income systematically laundered? (The foreign-loan scheme certainly would draw suspicion if it were an on-going affair.) How are large amounts of wealth moved out of a country with tight exchange controls in amounts so large as to render over- and under-invoicing ploys too awkward? Is it possible to bring extensive underground capital movements to the surface without the complicity of a government? Without some theory, questions cannot really be addressed, even though they purport to be the book's central themes.

One could conceivably write a similar book by searching a news data base for any story that

bore on shady international capital movements or international debt and then organizing the output on a geographic basis. The result of this process, like Naylor's text, could be densely footnoted and not too easily read. While it would heavily emphasize people and organizations and how they tend to be continuously entwined, the effort would fail, as does this book, to supply a fundamental understanding of why this facet of the world works the way it does.

Aside from these shortcomings vis-a-vis its basic purpose, *Hot Money* contains a disturbing amount of innuendo, and the author plays fast and loose with the abundance of facts, though not to any apparent end. For example, immediately following a paragraph discussing Cuba, Nicaragua, Robert Vesco, and a scheme to export Colombian cocaine to the United States comes the sentence: "Whether the major traffickers also planned, during their alleged meetings at the Vitoshi Hotel in Sofia, to finish the job Ali Agca left uncompleted has not yet been revealed." The rest of the paragraph discusses Nicaragua in the context of sending cocaine to the United States. Are cocaine traffickers intending to kill the Pope? The only reason to believe so seems to be their meeting in Bulgaria, which must be the source of the author's non sequitur. This is innuendo on a grand scale indeed.

Accounts of events surrounding high-stakes illegal and semi-legal transactions sprawl over the book's first 300 pages. Most of this sort of anecdotal material, taken in small and discrete doses, can be quite fascinating. The book suffers, however, from shoddy editing, in that the anecdotes tend to run into one another as each chapter progresses. Rather than developing points, by the end of most chapters paragraphs merely add bits to the stories. When all the facts are relayed, the chapters, like the paragraphs, abruptly come to a halt.

The same names recur throughout the book, a fact which should thrill some grand conspiracy fans. In this instance, though, the author is careful not to imply too much. It seems more likely that these people appear repeatedly because the text tends to focus on underground-capital movements, a relatively small component of total international capital transactions. Obviously, acting as an investment banker for a cocaine dealer entails immense risks that comparatively few international financial organizations are willing to shoulder. Thus, the bankers for the Latin American cocaine traffickers come from the same pool as those for the Pacific Basin heroin agents. It is no surprise that these people are all somehow affiliated with each other.

By the same token, one is not astonished that every major financial institution eventually is portrayed as being somehow involved with hot money. The whole point of both money laundering and underground capital movements is to take ill-gotten gains and put them to *legitimate* use. If U.S. Treasury securities are an attractive investment, then we should *expect* that erstwhile dirty, but untraceable, money will ultimately end up financing this country's deficit, along with other capital from around the world. To say that the Treasury or Citibank or General Motors benefits indirectly from hot money tells the readers nothing more than the fact that the laundering process was successful.

While the major banks show up frequently in Naylor's work as putative beneficiaries of the various forms of dirty money, they are portrayed even more negatively in the closing discussion of less developed countries' (LDC) debt. Again, the writing in this section is disjointed and anecdotal, jumping about both chronologically and geographically. Once more, the author provides disappointingly little explanation of the true state of affairs.

Overall, *Hot Money and the Politics of Debt* is quite disappointing. Because the author never establishes any intellectual foundation for analysis, he simply flits from anecdote to anecdote, factoid to factoid, in a manner that is immediately amusing but ultimately unsatisfying. The book is best suited for students writing papers on corrupt capital who do not want to find and read the original newspaper articles. Readers who wish to learn something about debt and about the manner in which the seamy side of international capital markets affects LDCs will have to look elsewhere.

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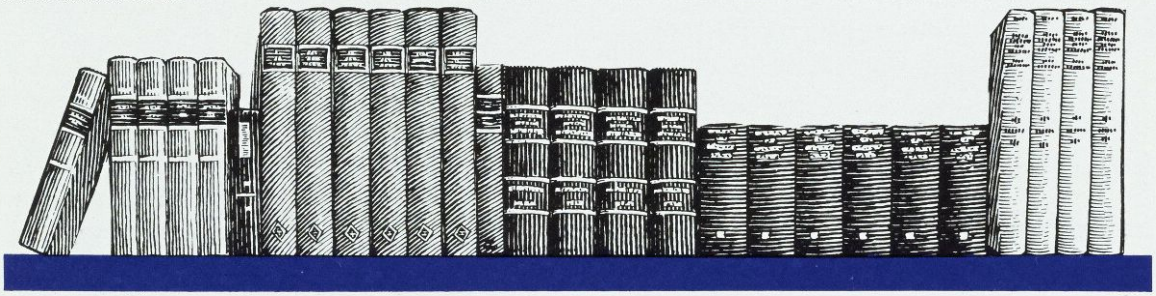
Book Review

Stock Market Activity in October 1987: The Brady, CFTC, and SEC Reports

Peter A. Abken



To what extent did the October 19, 1987, stock market crash result from a malfunctioning of market mechanisms? Analysts have grappled with this question since last fall; the answer is crucial to the development of future regulatory policies for financial markets.

Three particularly influential reports focus on the functioning of market mechanisms during October 1987 and propose ways to avoid a recurrence of such financial turmoil. These reports are the *Reports of the Presidential Task Force on Market Mechanisms* (the "Brady report"), the *Final Report on Stock Index Futures and Cash Market Activity during October 1987 to the U.S. Commodity Futures Trading Commission* (the "CFTC report"), and *The October 1987 Market Break* (the Securities and Exchange Commission [SEC] report). The following review concentrates on two major questions addressed in each of these studies: (1) what role did program trading play in the market decline, and (2) what, if anything, should be done about program trading?

This review focuses on the trading activity on two of the most important financial exchanges: the New York Stock Exchange (NYSE), where most of the stocks for major corporations are traded, and the Chicago Mercantile Exchange (CME), where the S&P 500 futures contract is traded. (More information on the S&P 500 futures can be found in this issue in the article by Kawaller, Koch, and Koch, "The Relationship between the S&P 500 Index and S&P 500 Index Futures Prices," p. 2.)

The NYSE and CME use two different market-making systems to facilitate transactions between buyer and seller. The NYSE is organized as a dealer market in which specialist firms are obligated to "make a market" in stocks that the exchange assigns to those companies. Their market-making responsibilities entail risk because the firms must take the opposite side of a transaction at a price close to the last transacted price if no one else will do so. The specialist is charged with maintaining an orderly market, which requires holding an inventory of stock, thus exposing the firm to price risk. Unlike the NYSE, the floor traders on the CME are not obligated to take positions in futures contracts; these traders act as brokers, matching buyer and seller. However, they also take positions in futures contracts, albeit briefly, to profit from price fluctuations caused by imbalances in buy and sell orders. In this respect, CME floor traders provide liquidity to the futures markets.

For markets in which price expectations are not changing sharply, the provision of liquidity enables stocks or futures contracts to be bought or sold with low transactions costs and fast

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execution at prices near the last transacted prices. What happens in these markets when broad-based uncertainty about price expectations is present, as in mid-October? Much of the controversy surrounding program trading—the institutional trading of all stocks in a program or index on which options or futures are traded—centers on the adequacy of market liquidity to accommodate trading when prices are changing rapidly.[1] Two relatively new program trading strategies at the heart of the debate over market function or dysfunction are stock-index arbitrage and portfolio insurance. Considered both singly and jointly, they are widely alleged to have exacerbated, and perhaps precipitated, the stock market collapse on Monday, October 19.

Despite background research and exhaustive reconstructions of events, the Brady Commission, the SEC, and the CFTC arrive at conflicting conclusions regarding the culpability of program trading. The Brady and SEC reports find program trading, and particularly portfolio insurance, significantly involved in both elevating market uncertainty as well as directly and indirectly driving stock prices lower than they would have fallen otherwise. The CFTC report, on the other hand, concludes that the crash resulted entirely from a massive change in investor price expectations, and the claim that program trading contributed significantly to the market break is unsubstantiated. Each of the reports details the mechanics of program trading. A brief overview here will lay the groundwork for a later discussion of the sources of disagreement among the market reports. Also, the November/December 1987 *Economic Review* included "An Introduction to Portfolio Insurance," which gives a thorough discussion of that topic, as well as references on stock-index arbitrage.

A Review of Program Trading Strategies

Stock-index arbitrage is the simpler of the two basic varieties of program trading. Stock-index arbitrageurs attempt to make riskless profits by exploiting price discrepancies between the S&P 500 index and S&P 500 futures prices. The flow of transactions on the CME and NYSE will generally be different, often driving index and futures prices away from their appropriate price relationship, known as the *basis*. For example, a negative basis, in which the futures price is below the index, indicates a price misalignment, provided all component stocks are being actively traded.

The activity of arbitrageurs tends to align stock and index prices. Arbitrageurs buy futures when futures prices are relatively low and simultaneously sell the stocks underlying the index when stock prices are relatively high, and vice versa. The arbitrageurs are said to be perfectly hedged because their return depends only on the relative movement of the futures vis-a-vis the index prices, not on the absolute change in their price levels. Their buy or sell orders for the component stocks are sent to the specialists via the NYSE's DOT (Designated Order Turnaround) system. Separate buy or sell orders for hundreds of S&P component stocks (not necessarily all stocks in the index) are routed to the specialists on the NYSE floor and are usually executed within minutes. Rapid execution is critical, for otherwise the arbitrageur is exposed to changes in the absolute price level of the index, not just the relative difference between the index and the index futures price. During volatile markets, the flow of arbitrage orders channeled almost instantly to specialists through the DOT system can be extremely heavy, leading to order imbalances that the specialists must try to absorb.

Portfolio insurance strategies involve systematic adjustments to a portfolio, typically an index portfolio, to limit its exposure to stock market fluctuations. The object of the strategy is to guarantee a prespecified rate of return on a portfolio over some predetermined time period. The strategy places part of a portfolio in "cash," that is, Treasury bills, and the remainder in equity. As the market rises, the equity component is increased by selling Treasury bills. When the market falls, portfolio managers increase the cash component. The same division of a portfolio into equity and cash components can be achieved using an equity portfolio and index futures contracts. By selling (going short) an appropriate number of index futures and holding the underlying stocks, any fraction of the equity portfolio can be converted into a hedged position that is equivalent to cash. In recent

years, most portfolio insurance has been implemented this way because the transactions costs of using futures are generally lower. It is important to bear in mind that portfolio insurance is a reactive, not speculative, trading technique: as the market declines, futures are sold; as it rises, futures are bought.

The Reports' Findings

Before the mid-October decline, many analysts were concerned about the potentially destabilizing interaction between index arbitrage and portfolio insurance trading. The SEC and CFTC reports discuss concerns about a so-called cascade scenario that was originally described in an SEC report following a sharp market decline in September 1986. The scenario begins with a decline in futures prices, for fundamental or other reasons, that triggers stock-index arbitrage. Arbitrage selling, in turn, depresses stock prices and affects the futures market via portfolio insurance futures selling in response to the stock market decline. Further arbitrage is induced, which in addition to setting off more portfolio insurance futures selling might also lead to stop-loss selling of individual stocks, liquidations due to margin calls, and so forth. The cycle intensifies and culminates with a market collapse.

After October 19, the cascade scenario, in one form or another, showed up in media accounts of the crash.[2] Each of the reports considers the interaction of portfolio insurance, and stock index futures trading generally, with stock index arbitrage. Much of the analysis in the CFTC report is devoted to disproving the cascade hypothesis.

The main differences between the Brady and SEC reports compared to the CFTC report regarding the role of program trading in the crash stem from the emphasis they place on psychological factors. Two important examples will be considered below. The different conclusions are especially striking in comparing the SEC and CFTC reports because the analyses in both reports were based on two shared data bases: (1) the special CFTC/SEC survey of the trading activity, particularly involving index arbitrage and portfolio insurance, of 16 firms that were major participants in both the stock and index futures markets in mid-October and (2) the CFTC's daily large-trader position reports on futures activity, which do not explicitly identify program trading. Staff interviews with key market participants during the mid-October period also supplemented the survey information.

Whether explicit or implicit, assumptions regarding the impact of extreme price volatility also contributed greatly to shaping each report's eventual conclusions and recommendations. The SEC report states that "[i]n conducting our analysis, we have adopted the fundamental assumption that extreme price volatility, such as occurred during the market break, is undesirable" (p. xi). They justify their viewpoint by pointing out that volatility reduces market liquidity, makes the provision of market-making services more costly and less efficient, and weakens investor confidence in equity investments. All of these adverse effects may ultimately reduce the rate of capital formation in the long run. Although not directly stated, the Brady report basically takes the same view of volatility. Their focus on market mechanisms is motivated by the "unusual frailty" that markets demonstrated in mid-October; individual markets suffered from an "illusion of liquidity." The CFTC report discusses episodes of short-term, technical pressures on stock or futures prices (that is, strained market liquidity), but, unlike the other reports, does not consider their potentially disruptive effects. To the CFTC, extreme volatility is a neutral consequence of extreme changes in market expectations.

"The main differences between the Brady and SEC reports compared to the CFTC report regarding the role of program trading in the crash stem from the emphasis they place on psychological factors."

The reports substantially agree on the fundamentals that appear to have set off the steep

decline in stock prices during the week before October 19. These factors were: (1) a merchandise trade deficit figure for August that showed less improvement than the market expected, (2) a continued depreciation of the dollar, (3) sharply higher short- and long-term interest rates, and (4) prospective tax legislation in Congress that would increase the costs of financing takeover activity. From Wednesday, October 14, to Friday, October 16, the Dow Jones Industrial Average (DJIA) closing changes from the previous day were -95, -58, and -108, respectively; the broader market indexes experienced similar large declines. Volume was extremely heavy and index arbitrage and portfolio insurance activity were likewise at a high level, although markets were not strained to the breaking point as they would be early in the following week.

"The reports substantially agree on the fundamentals that appear to have set off the steep decline in stock prices during the week before October 19."

Each report gives blow-by-blow details of intraday events in the various financial markets for these three days and those of the following week.

The October 14-16 period is of particular interest because the index arbitrage link between the CME and NYSE was functioning. Here the CFTC saw events differently from the Brady Commission and the SEC. Consider the then-record market decline on Friday, October 16. The CFTC report found that portfolio hedge activity, which includes portfolio insurance futures selling, was more or less evenly distributed throughout the day, with the greatest concentration of futures selling before 2:30 p.m. Index arbitrage sales were executed during the day in relatively concentrated intervals, especially toward the end of the day. At this time, though, part of the arbitrage was related to the expirations of some futures and options contracts (during the so-called "witching hour").

In analyzing the day's trading, the CFTC concluded that "neither the magnitudes nor the timing of this trading on October 16 is indicative of any significant interaction between portfolio hedging and index arbitrage sell programs" (p. 78). Neither the SEC report nor the Brady report focuses on portfolio insurance trading in terms of the cascade scenario. The SEC report states in a footnote that "this [cascade] scenario is far more simplistic than the multitude of factors influencing trading during the October market break. Nevertheless, the effects of futures selling on the stock market is relevant to what occurred" (p. 3-11). The Brady report also finds that during these days before October 19, "heavy arbitrage activity was most often coincident with substantial intraday stock market moves" (p. 29). This finding is not inconsistent with the CFTC report; the CFTC was not specifically concerned about index arbitrage-induced market volatility (see CFTC report, p. 79).

The Brady report goes further, asserting that "the market's decline [from Wednesday to Friday] created a huge overhang of selling pressure—enough to crush the equity markets in the following week" (p. 29). This overhang was concentrated within two groups of sellers: portfolio insurers and a few mutual fund groups needing to fulfill customer redemption orders. The Brady report maintains that on Friday, October 16, many market participants were on edge over the threat of continued selling pressure.

According to the Brady report, a number of aggressive "trading-oriented" institutions compounded the selling pressures by anticipating the reactive selling of the portfolio insurers and mutual funds and, concomitantly, selling ahead of them before further market declines. Of the $12 billion in stock that portfolio insurers needed to sell to meet the directives of their programs that week, only one-third had actually been sold, according to the Brady report. Both the CFTC report (p. 81) and SEC report (p. 3-12) mention the existence of an overhang of selling pressure, but neither give it the same emphasis as the Brady report.

Selling pressure during the NYSE opening on Monday, October 19, was in fact enormous.

Selling by institutional investors was the most significant factor, particularly at the opening. Index arbitrage selling was also prominent at the opening, although the CFTC states (pp. 91-92) that even during the morning, index arbitrage did not attain the concentrated levels of the previous week. Gross selling of S&P 500 futures for portfolio hedging purposes attained a record level of 20 percent of CME volume for the day; 80 percent of that hedge selling can be attributed specifically to portfolio insurance strategies (CFTC report, p. 93). Furthermore, one major pension fund, the largest portfolio insurance practitioner in the stock or futures markets, supplemented its futures sales with very large, periodic program sales of stock on the NYSE up until 2:00 p.m.

Each report documents how selling pressure was so powerful that the markets became congested. On the NYSE, in particular, the specialists were overwhelmed with sell orders. The imbalances led to late openings for many component stocks of the S&P 500 and to trading halts designed to give specialists time to work out these order imbalances. The reported futures basis was negative (that is, the futures price was below the index price) because the computation of the index value included many stock prices that were not current due to the disruptions in trading. The specialists' buying power was strained and liquidity dried up. The transactions costs of trading futures rose tremendously, making it difficult to match bids with offers. By early afternoon, the index arbitrage link between the exchanges was effectively severed because index arbitrage had become too risky, despite its apparent profitability. Trade execution times were highly uncertain. At this point in the early afternoon, as the Brady report puts it, both stock and futures markets went into freefall. The DJIA was down 508 points by the close; the broader indexes were likewise down by record amounts.

The Brady report comes close to describing the sequence of events on Monday in terms of the cascade scenario: "Portfolio insurers sold in the futures market, forcing prices down. The downward price pressure in the futures market was then transmitted to the stock market by index arbitrage and diverted portfolio insurance [stock] sales. While index arbitrageurs may not have accounted for a substantial part of total daily volume, they were particularly active during the day at times of substantial price movements. . . . [T]hey were the transmission mechanism for the pressures initiated by other institutions" (p. 42).

The SEC report emphasizes the timing of portfolio insurance and index arbitrage sales on Monday: "The periodic sell pressure from portfolio insurance related programs and more concentrated arbitrage sell programs sometimes hit the NYSE simultaneously" (p. A-29); "[t]he impact of the portfolio insurance stock selling combined with the impact of index arbitrage trading was the dominating force in the stock market during certain periods" (p. 3-12).

The CFTC report, in considering trading during the morning of October 19 before the arbitrage link broke down, found that "periods of high volume portfolio hedge sales in S&P 500 futures do not correspond with the periods of price weakness, nor do periods of low volume of such sales correspond with price recoveries" (p. 93). The report concludes that "the analysis of intraday trading does not support the contention that on October 19 the stock market fell as fast and as far as it did because of a continuously intensifying interaction between index arbitrage stock sales and portfolio insurance selling in the futures market" (p. 96).

"Each report documents how selling pressure was so powerful that the markets became congested. On the NYSE, in particular, the specialists were overwhelmed with sell orders."

The foregoing conclusions regarding the impact of program trading highlight the difference in interpretation of events on October 19. The intraday pattern of futures and stock price movements and their apparent correlation with intraday variations in trading of the various market participants does not in itself give convincing, clear-cut evidence about the

role of program trading. In each of the reports the method of analysis of the survey data basically amounted to an evaluation of the correlation of price movements with trading activity and evidently involved much subjective judgment.

Psychological Effects on the Market. In addition to studying the effects of program trading, the SEC and the Brady Commission go further to incorporate their evaluation of market psychology as a factor in explaining the market break. An important example involving psychological judgments concerns what the Brady report termed the "billboard" effect. As mentioned above, on the morning of October 19, the futures price was at a large discount to the index because many NYSE stocks were not trading. Was this a real or spurious discount? If real, the futures billboard would lead market participants to expect index arbitrage to drive stock prices lower. Buyers might be deterred from entering the stock market, and specialists might be hesitant to take the buy side just when the billboard is advertising a drop in the market.

"The Brady Commission makes the most sweeping, comprehensive recommendations for changing the way markets work and how they are regulated."

The CFTC report contains a section that corrects the value of the S&P 500 index for the so-called non-trading effect, something market participants had to do implicitly or explicitly. On Monday morning, the CFTC finds, the index arbitrage link was keeping futures and index prices aligned, and therefore the discount was spurious.[3] The CFTC believes it improbable that sophisticated broker/dealers "who conduct the majority of index arbitrage transactions [would respond] with massive futures/stock arbitrage programs to an illusory discount of the futures" (p. 19). In marked contrast, the Brady report gives the following account: "Ironically, the large discount on Monday morning was illusory. . . . Although the index arbitrageurs clearly knew that many stocks had not yet opened [on Monday morning], they nevertheless believed that a large discount existed. This belief led the index arbitrageurs to conclude that the market was headed much lower. . . ." (p. III-20). This excerpt illustrates the emphasis that the Brady report places on psychological assessments about what market participants thought was happening and what motivated them to act.

The Brady report's account of arbitrageur actions on Monday morning does not have a parallel account in the SEC report's detailed intraday market chronologies. Evidently, the Brady Commission based its evaluation of the billboard effect and other matters on interviews of market participants after the crash. The SEC also relied on interviews, although the SEC was more circumspect in their conclusions derived from such information. In contrast, the CFTC report downplays psychological factors influencing investor and market-maker behavior, concentrating instead on analyzing questions using the available data: intraday price movements, trading volume, trader positions, and so on. While the impact of investors' perceptions and fears on market activity is hard to determine, such evaluation appears to be an important and relevant part of the explanation for the mid-October decline. Though the Brady report emphasizes the importance of psychological factors—for example, the overhang and billboard effects—the report in some instances states judgments and conclusions with a certitude that seems inappropriate. The SEC report generally gives a more satisfactory account and analysis of market events because the report acknowledges the uncertainties that temper its conclusions.

The Reports' Recommendations

The recommendations of each of the reports are more difficult to compare than their analyses of the markets. The Brady Commission, the SEC, and the CFTC had different scopes and jurisdictions. The Brady Commission makes the most sweeping, comprehensive recommendations for changing the way markets work and how they are regulated. The CFTC, at the other

extreme, makes suggestions that involve the fewest changes, particularly to the regulatory structure.

The Brady Commission would like one agency to oversee intermarket issues. That responsibility, in their estimation, could perhaps best be carried out by the Federal Reserve. After the release of its report, the SEC expressed interest in taking over regulatory jurisdiction of stock-index futures trading, while, not surprisingly, the CFTC strongly argues against such a reallocation of responsibilities. In their respective reports, both the SEC and the CFTC suggest ways to improve interagency coordination, which, on the whole, they believed functioned well during the October crisis.

The Brady Commission recommends unifying clearing and credit mechanisms, which nearly disintegrated on October 20. Here, too, both the SEC and the CFTC call for more moderate refinements to the system. All reports agree that market surveillance and market information should be improved, especially in identifying customer trades and their timing.

The Brady Commission's proposal for "circuit-breaker" mechanisms such as price limits on futures and temporary trading halts on individual stocks are more or less consistent with positions taken by the CFTC and the SEC. To be effective, such circuit breakers need to be coordinated among markets. The Brady Commission and the SEC consider the "harmonizing" (the Brady Commission's term) of margin requirements across markets to be a useful step toward reducing price volatility. The CFTC emphatically rejects proposals to raise sharply the margins required on futures contracts. This divergence of views reflects, in part, differing assessments of what happened last October. The CFTC regards margin on futures as a performance bond to limit credit exposures, not as an extension of credit. They are not as concerned about intraday price volatility, nor do they believe that program trading is a significant source of that volatility. Although the Brady Commission and the SEC recognize the distinct functions of margin on stock and futures, both groups also are concerned about the concentration, size, and frequency of program-related trades and their impact on market liquidity.

To alleviate some of the liquidity strains that program trading may cause, the SEC recommends that the NYSE allow one or more well-capitalized specialists to trade market baskets of stocks. In their opinion, this market basket trading would add an additional layer of liquidity that would be more effective in dampening the price impacts of program trades than simply increasing the capital of specialists in individual stocks. This proposal, which had been discussed by academics and others before the crash, is a good example of a relatively small refinement of market mechanisms that has the promise of doing much for market liquidity and stability.

The appropriate course of action in the wake of the October 1987 market break still remains to be decided, and the various recommendations continue to stir controversy. In light of the uncertainties, incremental reforms appear to be prudent. Legislators and regulators should not rush to restructure either the market mechanisms or the regulatory system without much more compelling evidence that such changes would help markets and society at large.

Notes

[1] John Downes and Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms*, 2nd. ed. New York: Barrons, 1987, 311.

[2] Two examples are Anise C. Wallace, "A Suspect in Market's Plunge," *New York Times*, November 30, 1987; and George Melloan, "The Market Meltdown Made Phelan a Prophet," *Wall Street Journal*, October 26, 1987.

[3] The SEC did a similar analysis that is consistent with the CFTC's conclusion. See SEC, p. 2-13, footnote 49.

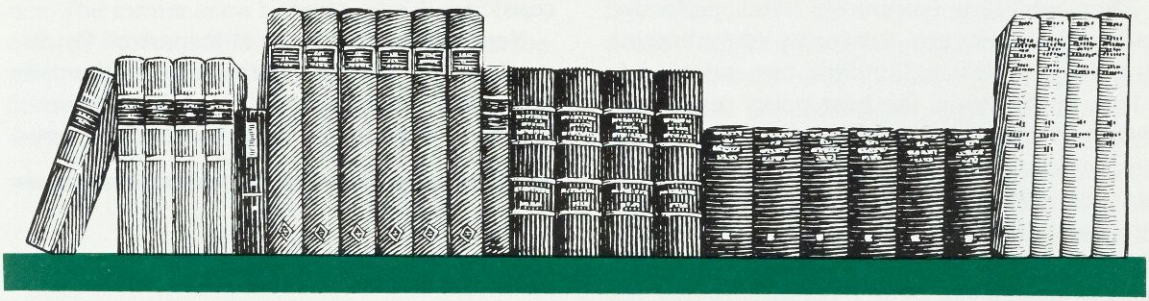
A Review of the Reports' Basic Findings

	Diagnoses	Recommendations		Other Comments
	Role of Program Trading in Crash	For Limits on Market Activity	For Regulation	
SEC	Significantly involved in elevating market uncertainty and driving stock prices lower than they would have fallen otherwise.	Price limits on futures. Temporary trading halts for individual stocks. Make margin requirements more uniform.	Improve interagency coordination.	Sees cascade scenario as oversimplified, but concludes futures trading did contribute to the crash. Moderate refinement of clearing and credit mechanisms recommended. Improve market surveillance and information. Allow a well-capitalized specialist to trade market baskets of stocks.
CFTC	Not a significant factor in the crash.	Price limits on futures. Do *not* sharply raise margins required on futures contracts.	Improve interagency coordination.	Disputes cascade scenario. Moderate refinement of clearing and credit mechanisms recommended. Improve market surveillance and information. Use intraday margin settlements.
Brady	Significantly involved in elevating market uncertainty and driving stock prices lower than they would have fallen otherwise.	Price limits on futures. Temporary trading halts for individual stocks. Make margin requirements more uniform. Emphasize restraints on trading coordinated across markets.	One agency, perhaps the Fed, to oversee intermarket issues.	Emphasizes overhang of selling pressure from October 14-16 and other psychological factors. Unification of clearing and credit mechanisms recommended. Improve market surveillance and information.

Book Review

Hard Heads, Soft Hearts

by Alan S. Blinder
Reading, MA: Addison-Wesley Publishing, 1987
236 pages. $17.95.



Alan Blinder introduces *Hard Heads, Soft Hearts,* his extensive discussion of economic policymaking, with an extremely discouraging generalization about the "remarkably systematic perversity in the way economic advice is used in policymaking." However, his "Murphy's Law of Economic Policy" appears to be well supported in a review of recent economic history. The "law" reads, "Economists have the least influence on policy where they know the most and are most agreed; they have the most influence on policy where they know the least and disagree most vehemently" (p. 1), and is accompanied by O'Connor's Corollary: "When conflicting economic advice is offered, only the worst will be taken" (p. 2). Recent events provide no shortage of examples illustrating these principles, and Professor Blinder, the Gordon S. Rentschler Memorial Professor of Economics at Princeton University, gives lively, lucid descriptions of these economic policy debacles. Still, the book is optimistic, on balance, about the prospects for improving both economic policymaking and, subsequently, economic conditions. *Hard Heads, Soft Hearts* should find wide support in the economics community.

The body of this book is a series of persuasive arguments that show how profoundly flawed policy came to be, and how it could be changed to yield greatly improved results. As Professor Blinder sees it, the greatest obstacles to better economic policy are "ignorance, ideology, and interest groups" (p. 197). Some combination of the three, he claims, is responsible for the federal budget deficit crisis, the recent increase in protectionist legislation, and the disappointing results of the environmental pollution abatement legislation of the 1970s, among other societal ills. The ravages of ignorance receive the most attention; Blinder feels that ignorance may be the one obstacle on which economists can have the greatest constructive impact, because increased public knowledge about economic policy will lessen the influence of ideology and interest groups.

Few economists or public policy analysts will disagree with Professor Blinder on these points. In fact, despair over the public's general contempt for the facts unites otherwise contentious parties. Consider that James David Barber, a Duke University political scientist typically supportive of liberal policy initiatives, and Paul Craig Roberts, a promulgator of supply-side economics, seem of one mind on this issue. Barber comments, "We've had a lot of anti-empiricism in national discourse. Political discourse has

been reduced to a balance of sentiments."[1] In the same vein, Roberts states, "Economic policymaking is hopeless if facts cannot penetrate public discourse."[2]

Blinder faults economists, among others, for this pervasive ignorance. He argues that while bad policy is based on "gross misunderstanding of elementary economics, utter disregard for the facts, or both," economists have failed to convince the public, and so the policymakers, that good policy tends to be "too complex to be emblazoned on a T-shirt," and that good policy is, in fact, "[l]ess crisply defined and full of qualifications" (p. 9).

Not only have economists been ineffective educators, they are also guilty of embracing ideology. Professor Blinder's own position is clear. In this book, the best policy rejects the extreme prescriptions of monetarism, rational expectations, and especially supply-side economics, in favor of a broadly based and proven Keynesian approach. Unfortunately, Professor Blinder trivializes and dismisses the contributions of these other models. However, the practical Keynesian view he takes has benefited in no small way from the broadening forced upon it by these competing approaches. In fact, the Keynesianism he describes does not much resemble the original animal. It is an eclectic mix, having been forced to acknowledge the critical importance of monetary policy, expectations formation, and the incentive structure built into tax rates.

The cold-blooded discussion of policy failures and limitations at the outset of the book gives way to a rigorous defense of economics as a discipline able to promote the general welfare of all U.S. citizens. That is, economics is an ivory tower discipline, but one that operates in the real world. This discipline can be most valuable when the high road of theory meets the low road of extensive practical experience.

The author's strategy in *Hard Heads, Soft Hearts* is to introduce the reader to two of the most fundamental concepts of economic analysis: efficiency and equity, both of which are generally acceptable as reasonable goals for public policy. Efficiency requires that resources (for example, labor, capital, clean air, and oil) not be wasted. Equity requires that resources be distributed fairly. Taken in turn, each principle is uncontroversial. Clearly, however, a policy that advances one of these goals often hinders the other. The obvious example is tax policy, in that the distortionary or disincentive influences of tax policies which redistribute income may discourage the most efficient use of resources.

Professor Blinder also shows why the free market system, which he rigorously supports, tends to produce inequities. He does not compare the degree of inequality in a free market economy with that of a command economy because he asserts, without argument, that the free market is superior. Although the system of rewards and incentives that produces the most efficient outcome "shows no mercy," Blinder considers this an asset.

Next comes a sly tactical maneuver. By discussing policy changes that increase *both* equity and efficiency, Professor Blinder avoids some of the uglier problems of the trade-off between these two concepts that bedevil so much of the economic policy debate. Surprisingly, many important policies are not eliminated by these narrow criteria.

"The cold-blooded discussion of policy failures and limitations . . . gives way to a rigorous defense of economics as a discipline able to promote the general welfare of all U.S. citizens."

Professor Blinder's preferences and biases are very much on the side of weighting inequity over inefficiency as Bad Things, and he admits this forthrightly. The waste associated with unemployment is much more passionately condemned than the costs of inflation. This assessment is clearly reflected in the author's willingness to accept more inflation for less unemployment. By extension, he argues that the cost of the anti-inflation policies of the early 1980s was unconscionably (although not unnecessarily) high. This section of the book (chapters 2 and 3) is high-minded and compassionate, but gives little attention to the distinction between stable and rising inflation rates, a distinction that played a major role in

deciding upon the tough policies earlier in this decade.

In his discussion of the cost of low, stable inflation Blinder suggests that with indexation even these moderate costs could be reduced considerably. However, in the current institutional and cultural setting in the United States, inflation tends to accelerate, not remain constant, once it is widely recognized. Rising moderate inflation soon becomes decidedly immoderate, and the attendant costs and distortions are immensely destructive. The distinction between low inflation and rising inflation is at once important in theory and fleeting in practice. The former soon becomes the latter. Thus, much of Professor Blinder's argument about the minimal costs of inflation, and the attendant condemnation of the anti-inflation policies of the early 1980s, seems to rest on a narrow precedent not supported by recent history.

"The discussion of environmental policy is almost heartbreaking in its description of opportunities lost."

The discussion of the inequities and inefficiencies of recent anti-inflation policy is probably the most controversial part of the book. Surprisingly, Professor Blinder uses a clearly contentious issue to illustrate the economics profession's consensus on the equity/efficiency principle. Equally surprising is that this illustration does not materially weaken the remainder of his work, possibly because his other examples involve issues where strong professional solidarity exists. Blinder also takes on protectionism, pollution control, and tax reform. In each case he shows how the principles of efficiency and equity and the prescriptions of the overwhelming majority of the economics profession have often been ignored in policymaking to the detriment of the common good.

In the best part of the book, Blinder discusses the principles of free trade and the mindless, needless waste of protectionism. The clear exposition of the idea of comparative advantage is sophisticated enough to allow Professor Blinder to debunk a series of protectionist arguments without preaching on the costs of protectionism. But then he does so, with a flurry of statistics illustrating the colossal waste of such policies.

For example, Professor Blinder describes how the "voluntary" export restraints imposed on the Japanese automobile industry in 1981 saved a number of jobs in the U.S. auto industry and increased profits for auto industry shareholders. A reasonable estimate of the bill for this relief is $13 billion; about $8 billion went to domestic producers and roughly $5 billion went to the Japanese auto industry. This $13 billion represents the additional cost to U.S. consumers of cars purchased in the United States in 1984 and 1985 only. The cost *per job saved* is variously estimated between $105,000 and $160,000. Did any individual auto worker benefit to the tune of $160,000? The case of the voluntary export constraints is an example of the general rule that the benefits and costs of protectionism are distributed very differently: "trade protection typically imposes heavy costs on consumers in order to secure smaller benefits for producers" (p. 118).

The discussion of environmental policy is almost heartbreaking in its description of opportunities lost. Professor Blinder shows how the imposition of property rights on otherwise free resources (clean air and water) would make society recognize how valuable and scarce they are. Currently, most pollution abatement laws are one of two types: ambient air and water standards that set the minimum acceptable quality of air or water after a plant has finished using it, and effluent or emission standards that specify the amounts of a pollutant that may be discharged from a particular source. Apparently, many of the standards now on the books are not being met because companies find it cheaper to "invest in litigation than in pollution abatement equipment" (p. 144). Professor Blinder contends that if the rights to use air and water resources were licensed, or auctioned, these precious resources would be used more rationally and with fewer harmful results. Without using economist's jargon, he shows that by forcing industry to internalize the costs that are

currently externalized (all of society—not just industry—pays for and suffers from dirty air and water), much less pollution would occur. Additionally, companies would have an incentive to minimize pollution, since pollution control costs would become an element of production costs. Conservative estimates of the economic gain from a switch to a system of fees or pollution permits from the current labyrinth of regulations are huge, on the order of $23 billion per year. Have any experiments with pollution permits ever been tried? Yes, but only a few. Limited evidence indicates that the potential gains are indeed as substantial as the estimates suggest.

The disheartening rejection of economic principles seen in protectionism and environmental policy is not universal. In chapter 6 of *Hard Heads, Soft Hearts,* Professor Blinder recounts the triumph of equity and efficiency in the "improbable saga of tax reform." Readers are shown how a system that in the past served as an example of the power of the few (special interests) over the many was used to affect tax reform, enhancing both equity and efficiency. Unfortunately, economic principles prevail in only this one chapter; in many, many unwritten chapters, they do not.

The book ends with a prescription to reverse this situation. Professor Blinder calls for pragmatism to fight the ideology that harbors untruths, for the support of forces to counter the influence of special interests, and for education. Economists can realistically address only the last of these remedies. Unfortunately, they have failed to do their best to educate the electorate and the elected on the benefits of good economics as much as the public has failed to use the advice economists have offered. Economists know that economics is an extremely powerful tool that can be used in almost all areas of public policy. However, this discipline is not very accessible to the public, let alone the policymakers. As Blinder writes, "economic illiteracy is widespread."

Hard Heads, Soft Hearts stands as an example of the sort of book that will help raise the level of economic discussion among non-economists. Blinder's work can be part of the solution; his book is gracefully written and clearly reasoned, with its mild ideology worn on its sleeve. It is cold-bloodedly realistic but also optimistic, two traits that economists will have to adopt to revoke "Murphy's Law of Economic Policy."

Mary Susan Rosenbaum

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Notes

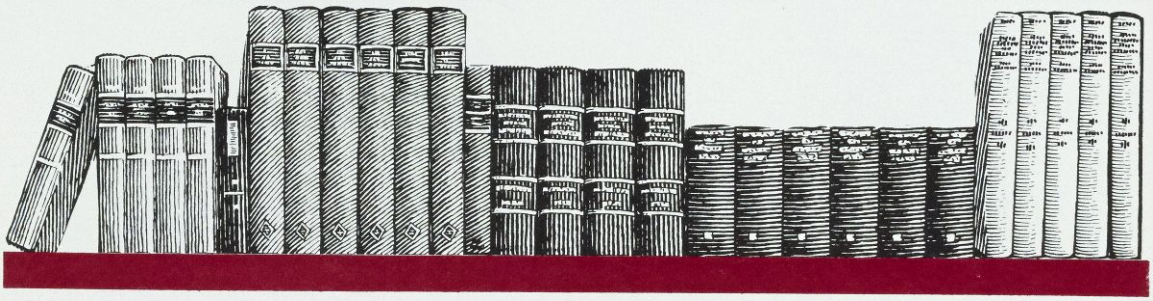
[1] Peter Kilburn, "The Sudden Wilting of Reagan's Rosy Economy," *The New York Times,* Sunday, July 27, 1986, sec. 3.

[2] Paul Craig Roberts, "Beneath the Twin Towers of Debt," *Wall Street Journal,* October 28, 1986.

Book Review

Buying into America

by Martin and Susan Tolchin
New York: Times Books, 1988.
400 pages. $19.95.



Foreign investment in the United States is becoming more widespread and significant in value each day. Not only financial assets like U.S. government securities and corporate stocks and bonds but also real assets such as office buildings, manufacturing plants, forestland, and beachfront properties are coming under increased foreign control. In their latest book, *Buying into America,* Martin and Susan Tolchin document and describe the growing scope of these activities, note how defenders of the trend justify this surge of foreign investment, and review the long-term costs that such investments may entail for the nation.

This book has received much publicity, largely because of its wealth of information on a popular topic. Americans are uncertain about the long-run consequences of foreign investment and appear to be growing more apprehensive as the pace of such activity accelerates. One of the authors' stated purposes in writing the book was to heighten awareness and concern over the potentially costly impacts of foreign investment they see for Americans.

Martin and Susan Tolchin form a politically savvy and veteran writing team. He is a correspondent in the Washington bureau of *The New York Times,* and she is a professor of public administration in the School of Government and Business Administration at George Washington University. They seem to have a faculty for writing about topics that touch a public nerve and are in vogue in the politically charged public policy arena. Titles of their previous books—*Dismantling America: The Rush to Deregulate; Clout: Womanpower and Politics;* and *To the Victor: Political Patronage from the Clubhouse to the White House*—demonstrate this bent.

In *Buying into America: How Foreign Money Is Changing the Face of Our Nation,* the husband-wife team concludes that foreign investment in the United States definitely is not without its costs. Tolchin and Tolchin argue that the influx of foreign money into the U.S. economy poses a severe threat to the ability of the United States to control its fate and defend its position as a premier industrial power. Opening paragraphs in the book refer to "mayors, governors and cabinet officers . . . circling the globe in quest of foreign funds, with the intensity of third-world ministers trying to stave off the financial collapse of their shaky governments." Moreover, the authors assert, "under pressure to bring home the bacon, politicians have paid scant attention to the long-run economic, political, and social effects of their country's deepening dependence on foreign money." The Tolchins are, of course, partly right. By adopting a xeno-

phobic tone, however, they divert too much attention away from important macroeconomic issues with greater influences on American society—for example, the low U.S. saving rate and large government budget deficits.

The story told by the Tolchins can be summarized as follows: The United States—government and citizens alike—is spending too much, and foreign lenders are financing the consumption spree. In the process, foreigners are acquiring U.S. financial and real assets so quickly and in such large amounts that they have accumulated significant economic and political clout here. Unless something is done soon to slow or reverse our dependence on foreign money, which has made the United States the world's biggest debtor, Americans are in extreme danger of mortgaging their future and reverting to colonial status. In a nutshell, they argue, America is spending its way into the poorhouse by borrowing for consumption rather than using the funds to expand or develop industrial capacity.

Worse yet, in Tolchin and Tolchin's view, the United States seems to be giving away the proverbial farm with open-door, laissez-faire national trade and investment policies, and state governments are needlessly providing extravagant subsidies to lure foreigners here. Meanwhile, the authors portray foreign businesses and governments—both separately and together—as accelerating this nation's economic and political demise by means of sinister and subversive plots. The writers note, for example, that foreign corporations may try to buy into critical defense-related manufacturing activities to acquire technology; sometimes, foreign governments encourage such activities and may even subsidize unfair competitive practices. National security can, of course, be compromised because of such actions. The authors also point to a moral issue: the openness of the U.S. financial system has encouraged, albeit incidentally, capital flight to the United States from dictators and criminals seeking a safe repository for their ill-gotten gains.

The Tolchins argue persuasively that the significant and fast-growing net-debtor status of the United States should generate concern among its citizens. Reliance on foreign money to finance a consumption binge certainly entails long-run costs in the form of an interest and debt repayment burden that threatens to grow even heavier over the next few years. The authors also assert—with some validity—that competition among states for foreign direct investment has led to excessive subsidies in the form of cheap land, tax holidays, job training, grants, and other breaks. Such competition among state and local governments can be wasteful and cause a cleavage between national and local interests. In instances when the investment would have been made without the inducement, the long-run profitability or benefit to the United States is suboptimal.

While some foreign investment incentives seem questionable, the Tolchins fail to recognize that the jobs, tax revenues, and other benefits that result generally warrant such lures. Moreover, foreign investment may promote economic growth and enhance the ability of domestic industries to compete, thus adding jobs to the host economy. Such investment often brings innovative management techniques and better technology along with new plants or equipment. Local government leaders are keenly aware of these and other benefits; investment may boost employment, improve the community's economic diversity, and support its property and payroll tax base even when investment incentives are provided.

Among the Tolchins' other concerns, national security issues are legitimate. Fortunately, safeguards have already been developed; for example, defense contracts cannot be awarded to firms that are more than 25 percent foreign-owned, and investments in a few sensitive industries are prohibited. As a practical matter, though, determining which industries qualify for safeguard treatment is difficult, suggesting that industrial restrictions should be used sparingly lest certain industries' competitive edge be dulled by insulation and protection.

The Tolchins' other objections to foreign investment stem from their belief that foreigners' interest in the United States derives from a desire to avoid protective tariffs, to acquire new technology, to gain a foothold in the large and affluent U.S. market, or simply to make money. Yet these motivations are not as sinister as the light in which this book casts them; indeed, a prevailing view among economists holds that world resource allocation is improved to the extent that foreign investment is market-driven

and lured by the profitability criterion. Once here, foreign investors should want the U.S. economy to operate as profitably and efficiently as possible. What's more, foreigners' efforts to avoid protective tariffs, acquire new technology, and increase market shares are common to virtually all businesses, regardless of their geographical bases, political motivations, or the areas into which expansion is projected.

In *Buying into America,* the Tolchins achieve success in publicizing what they regard as the potential dangers of foreign investment in the United States, thus meeting one of their major goals. Unfortunately, they are not as successful in reaching another major purpose—accurately describing how foreign money is changing the face of our nation. This objective is not met because the Tolchins overstate the dangers of foreign investment and give short shrift to its benefits. This shortcoming of *Buying into America* is particularly reflected in the shotgun approach taken regarding interactions between the United States and the rest of the world. The authors bring up such diverse incidents as clandestine Moscow-directed economic warfare and third-world-initiated money laundering along with open and aboveboard international economic transactions such as foreign corporations' establishment of manufacturing plants in the United States and foreigners' portfolio purchases of U.S. stocks and bonds. Moreover, Tolchin and Tolchin essentially lump these disparate interactions together as *all* being costly to the United States.

The unbalanced treatment of the issues in *Buying into America* is, perhaps, motivated by the authors' strong desire to call attention to the dangers of foreign investment, but they still go too far. Imbalance is also created by confusing consequences with causation: investment often is a response to a problem rather than the root of a problem. For example, if the United States is indeed on a consumption spree, as the Tolchins assert, the condemnation of foreigners who are willing to finance this consumption is neither a practical nor a charitable stance.

In assessing the merits of foreign investment, two fundamental issues need to be addressed. First, an analyst should determine whether foreign investment in the United States is creating wealth or simply redistributing existing wealth. The Tolchins vaguely address this question with loose assertions that long-run "costs" such as profits, interest, dividend, and principal repatriation may outweigh short-term employment gains created by foreign investment. However, *Buying into America* definitely does not attempt to analyze the costs and benefits of foreign investment in a methodologically sound and empirical framework.

A typical example of the type of no-win situation that the Tolchins depict concerns foreign investment in the real estate market. They write that "foreign investors often contribute to soaring real estate prices," but in the same paragraph they state that "foreign investors conduct distress sales that take the bottom out of U.S. real estate markets." The authors also downplay the impact of jobs created by foreign investments while suggesting, incorrectly, that foreigners dominate entire industries; as measured by employment, U.S. affiliates of foreign manufacturers constituted under 8 percent of the work force in 1986 and exceeded 10 percent in only a few industries.

The second important issue to be considered in evaluating foreign investment is whether our relatively receptive and open economic environment is preferred to one with more government intervention in markets involving international activities. The Tolchins' philosophical answer, like protectionists' on the narrower trade issue, is clear: they recommend much greater government intervention via information gathering and control of activities. The Tolchins seem either not to recognize or to ignore the fact that increased government involvement could also generate substantial costs for our economic system in the form of inefficiencies.

Beyond the direct costs associated with increased U.S. government surveillance and intervention, potentially large costs to the private sector might also ensue from the adoption of measures that restrict capital flows. Official U.S. balance of payments statistics for 1987 show that the flow of foreign direct investment (for property, plant, and equipment) to the United States was $41.5 billion during 1987, but U.S. companies did even more direct investment abroad ($49.3 billion). Moreover, the stock of U.S. direct investment abroad is much larger than what foreigners own here as a result of large U.S. outflows during the past several decades.

Foreign Investment: The Tolchins' Myths, Costs, and Recommendations

Recitation of the Tolchins' nine "myths" of foreign investment is daunting, and their list of major potential economic and political costs of foreign investment is frightening. So, too, for that matter, are many of their recommendations.

For the Tolchins, the perpetuation of the following myths is the real problem because they engender a paralyzing resistance to changes in public policy:

- foreign capital will help America rebuild its industrial capacity;
- foreign investment is separate from trade policy;
- investment policy exists apart from foreign policy;
- foreign investments are a sign of America's economic health;
- money is neutral, not political, and investors are interested in profit, not power;
- U.S. policymakers and the American people have enough information on which to base intelligent decisions;
- no changes are needed in the current U.S. laissez-faire policy toward foreign investment;
- foreign investment and free trade are the same thing; and
- foreign investment helps American business.

The writers suggest that each of the following cost items entails a significant offset to the limited job-creating benefits of foreign investment:

- U.S. political and economic independence is lost;
- foreign corporations eliminate U.S. industrial competition with peremptory strikes;
- states give foreign investors extravagant concessions;
- foreign corporations are antagonistic to U.S. workers' unionization rights; and
- foreign investment will eventually worsen U.S. budget and trade deficits.

The Tolchin solution to the challenge of foreign investment is a much-expanded role for the U.S. government in monitoring and controlling international economic transactions. Government must:

- shield citizens from the negative impact of foreign investment and assert some control over its future direction;
- require a policy of full disclosure of foreigners' investments in this nation;
- identify the benefits of foreign investment and reinforce state efforts to maximize those benefits;
- study the points at which foreign investment weakens U.S. national security and take measures to limit those investments;
- take a hard look at foreign investors as employers and identify their shortcomings along with their strengths;
- control foreign investment when it is inimical to American business or American interests;
- recognize the U.S. bargaining position and negotiate from strength; and
- demand a level playing field and reciprocity abroad.

The most severe shortcoming of this book, though, is that it is anecdotal (and repetitive at that) rather than analytical. How foreign money is changing the face of our nation is an important topic for research. Careful analysis, however, is required to determine the ways in which this change is taking place. Moreover, important distinctions should be made when discussing the topic of foreign investment. Taking these distinctions into account and employing an analytical framework would produce a much more useful, and less polemical, product.

Specifically, it is crucial from an economic perspective to distinguish foreign portfolio

investment, which may be an accommodating consequence of U.S. budget and trade deficits, from foreign direct investment in real assets. An appropriate discussion would reflect on the causes and consequences of direct versus portfolio investment and include some quantitative estimation of the macroeconomic impacts of the different types of capital flows. Clearly, the employment effect of a foreign auto manufacturer locating an assembly plant in this country is much different from that of a foreign pension fund's purchase of the federal government's latest bond issue. Furthermore, neither of these activities bears much resemblance to nefarious international transactions in terms of political or social effects.

The intrusion of foreign money into an economy is not a new issue. In light of this fact, an appropriate stance on the part of the United States and other countries receiving foreign investment would be to realize that the world is increasingly interdependent and that, while interdependency has its costs, its benefits are often much better.

William J. Kahley

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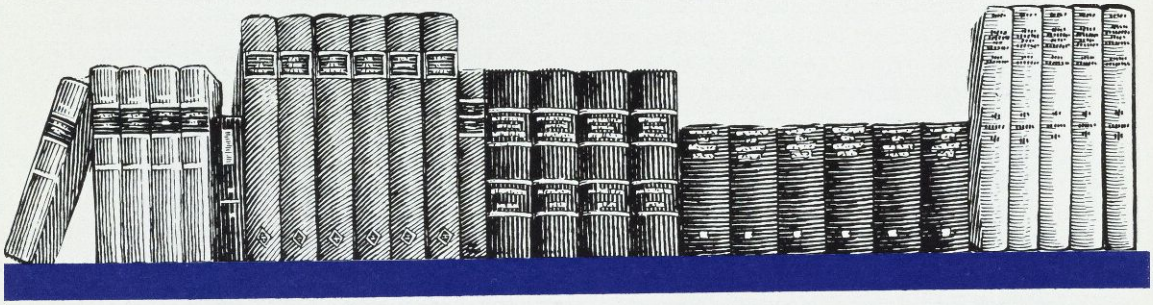
Book Review

The Gathering Crisis in Deposit Insurance

by Edward J. Kane
Cambridge, Mass.: MIT Press, 1985.
176 pages. $14.95.



Originally published in 1985, Edward J. Kane's *The Gathering Crisis in Deposit Insurance* takes on additional importance given the current emergency in our nation's deposit insurance programs. When the book was written, the reserves in U.S. deposit insurance funds were just beginning to show signs of decline. Since 1985, however, the rapid deterioration of the reserves of the Federal Savings and Loan Insurance Corporation (FSLIC) has resulted in that fund's insolvency and the need for a massive infusion of federal aid.

What caused this crisis, and what are some possible long-term solutions? The reader of *The Gathering Crisis in Deposit Insurance* will find the answers to these questions and much more. Professor Kane, who holds the Reese Chair of Banking at Ohio State University and is an internationally acclaimed banking scholar, provides a comprehensive overview and detailed economic analysis of the problems surrounding the nation's federal deposit insurance programs. The fact that Kane first began writing this book in early 1983—almost three years before the FSLIC was officially declared insolvent—only confirms the depth of Professor Kane's insight into the structure and workings of this nation's deposit insurance system. This insight is even more remarkable in light of the recent actions of the Federal Home Loan Bank Board. To appreciate properly, then, the author's understanding of the deposit insurance dilemma, an overview of the current status of this crisis is in order.

Deposit Insurance: How the Problem of Zombie Thrifts Evolved

On Friday, August 19, 1988, the Federal Home Loan Bank Board, overseer of the nation's federally chartered savings and loan associations and savings banks, announced a stunning multibillion-dollar FSLIC bailout of eight insolvent Texas thrift institutions. At that time the bailout, estimated to cost the FSLIC between $2.5 billion and $5.5 billion, represented the most costly multiple rescue ever undertaken by the fund. The bailout may have also signaled an end to the era of high-risk investment strategies which have been pursued by many of the nation's now-troubled thrift institutions.

The beginning of the problem thrift period can be traced back to the late 1970s when rising interest rates shrank the spread between the rates thrifts earned on their long-term asset portfolios, principally mortgages, and the rate

they paid on their primarily short-term deposit liabilities. As the 1980s arrived and profit margins continued to be squeezed, many already-weakened thrifts tried to improve their earnings performance by undertaking speculative high-risk investment strategies. Needless to say, many of these weak institutions suffered equity-eroding losses as the high-risk investments proved unsuccessful. Certain institutions were in such dire financial condition that Kane coined the now-popular phrase "zombie thrifts," referring to institutions that are still operating but financially moribund.

The term "zombie" has most often been applied to problem thrifts in Texas. These institutions are also the ones that pursued the most speculative investment strategies and that were devastated by the collapse of the oil economy. In Texas, the thrift problem is so severe that an estimated 100-plus thrifts are currently in need of rescue. Although the crisis is concentrated in the so-called oil patch—Texas, Oklahoma, and Louisiana—zombie thrifts are by no means located only in this geographic area.

On August 10, 1987, President Reagan signed legislation that provided $10.8 billion for the insolvent FSLIC. This assistance package is part of the Competitive Equality Banking Act of 1987, which allowed the Federal Home Loan Bank Board to create a new entity, the Financing Corporation, which serves as the vehicle for replenishing the thrift insurance fund.[1] Funds to recapitalize the FSLIC will come from bonds sold in the capital markets. Interest payments on the debt will be made from assessments on FSLIC-insured thrifts, while the principal will be backed by zero-coupon long-term Treasury bonds bought with the proceeds of the bond issues.

This recapitalization plan is not without its own risks, however. First, the $10.8 billion capital infusion approved by Congress for thrift rescues nationwide is significantly less than the $15.2 billion that Home Loan Bank Board Chairman M. Danny Wall estimates will be required to clean up the thrift problem in Texas alone. The likelihood of such a shortfall is very real for the insurance fund, which former Home Loan Chairman Edwin J. Gray in early 1987 told Congress was losing $10 million per day. Even if one takes the approximate $20 billion available to the FSLIC through the year 1990, estimates of the total cost of liquidating insolvent thrifts nationwide range from $45 billion to a staggering $65 billion.[2] Second, given that they will in effect be subsidizing insolvent and perhaps poorly managed zombie institutions, many healthy, well-managed thrifts may actually withdraw from the FSLIC after a one-year moratorium. Finally, the weakest institutions may not even be able to meet the assessments required to service the bonds.

One often-proposed solution to the current thrift crisis is to merge the FSLIC with the much healthier Federal Deposit Insurance Corporation (FDIC), which insures the deposits at the nation's commercial banks and, like the FSLIC, has prime responsibility for handling insolvent institutions. The rationale underlying this proposal derives from the fact that the FDIC began 1988 with roughly $18 billion in reserves in addition to an annual income from premium assessments of roughly $3.3 billion.

Though a merger between the nation's two most important deposit insurers seems plausible, according to noted financial consultant Dan Brumbaugh, Jr., and banking law scholar Robert Litan, the FDIC may soon be unable to fund the cost of closing all insolvent commercial banks and may itself be headed towards a fate similar to the FSLIC's.[3] Brumbaugh and Litan base their conjecture on an analysis of the capital base of the nation's commercial banks with over $50 million in total assets. This analysis, which is conducted relative to the cushion available to the FDIC in the event of bank failures, focuses on the growth of insolvent commercial banks during the 1986-87 period.

Although many analysts will no doubt disagree with the Brumbaugh-Litan conjecture, their analysis does raise questions about the financial strength of the FDIC. Factors that Brumbaugh and Litan cite as contributing to the overvaluation of the deposit insurer's financial strength include the use of generally accepted accounting principles that tend to overstate the true value of bank capital and understate insolvency risk, the presence of inadequate loan loss reserves for the Third World loans being carried on bank balance sheets, and the overstating of the value of domestic real estate owned by banks.

Kane's Analysis: Deposit Insurance Problems and Solutions

In analyzing U.S. deposit insurance programs—that is, the programs of the FSLIC, the FDIC, and the National Credit Union Share Insurance Fund—Professor Kane provides a masterful analysis of the incentive problems that arise in deposit insurance relationships. These problems occur (1) when the insurance premiums charged to institutions are actuarially unfounded—in other words, not related to the underlying riskiness of the insured institution—and (2) when regulatory policy further retards market discipline from operating to keep risk-return relationships in balance.

The presence of risk-insensitive premiums leads to the insurance problems of moral hazard and adverse selection. Moral hazard arises when the presence and structure of insurance change the incentives of the insured to exercise proper care under the insurance contract. The problem of adverse selection exists when the insured presents more of a risk to the insurer than the insurer can detect from the information provided. Both problems result in insured parties' taking excessive risks since the insurance premiums do not cover the insurer's expected losses.

With fixed-rate deposit insurance, one can understand why Kane's zombie thrifts pursue high-risk investment strategies. By bidding for deposits at premium rates, these institutions are actually issuing contingent claims on the insurance funds. If the high-risk, high-return projects financed by these deposits pay off, then the institution makes handsome returns. On the other hand, if these projects fail, the management can basically walk away, leaving the problem on the insurance agency's doorstep. Thus, their behavior can be likened to a Ponzi scheme or a game of "heads I win, tails you lose."

Kane's exposition is divided into six chapters. Chapter 1 introduces the reader to the general regulatory environment of financial institutions and reviews the nature of the incentive problems along with suggestions for reform of the deposit insurance system. Chapter 2 examines the preferred procedures that federal regulators use for handling insolvent depository institutions. Professor Kane discusses how delayed closings and the preference of the insurance agencies for purchases and assumptions of insolvent institutions by solvent ones actually dull the market's ability to discipline management, thus allowing further risk-taking on the part of banks and thrifts. These actions lead to a significant weakening of the deposit insurance funds. Professor Kane provides statistical support for this claim with data based on FDIC- and FSLIC-assisted mergers that occurred during the early 1980s.

Chapter 3 describes in some detail the major types of risk that bank and thrift managements have assumed as a result of an inefficient deposit insurance program. The author presents numerical estimates on the exposure of the insurance funds along with their loss experience over the 15 years prior to 1985. The interested reader should compare Professor Kane's estimates with those cited in the introduction of this review. Clearly, regulatory policy has not kept pace with the ability of institution managers to add risk to their portfolios.

Interest-rate risk is covered in chapter 4. Basically, the author shows how interest-rate risk—the loss of market value of assets as a result of changes in market interest rates—can be considered equivalent to the default of part of an institution's mortgage portfolio. Using this equivalence relationship, Kane examines pseudodefault rates on the mortgage holdings of insured thrifts, savings and loans, and mutual savings banks over several years. This chapter also includes several methods for estimating the value of deposit insurance to insured institutions. These methods range from a simple percentage of insured deposits to the use of the rather sophisticated option pricing models of modern financial economics.

Chapter 5 of the book concentrates on the risk associated with lending to less developed countries (LDCs). The magnitude of the LDC debt crisis is related to the magnitude of federal default guarantees. Professor Kane argues that the establishment of a secondary market for this debt would help resolve the crisis by establishing market values for the debt. These could then be used to restructure the loans on the institutions' books. However, this approach may be unacceptable as it would require substantial reductions in the book equity of the institutions affected.

The final chapter presents Professor Kane's broad-based proposals for deposit insurance reform. For example, the use of market value measures, as opposed to historical valuation, is proposed. In addition, risk-based deposit insurance premiums are suggested as another way to alleviate the incentive problems associated with the current deposit insurance program. Finally, Kane recommends implementing statutory restrictions on the ability of regulatory bodies to keep insolvent institutions operating.

A 1988 Perspective on Kane's Analysis

Taken as a whole or separately, the author's proposals are certainly steps in the right direction and could form part of the basis for serious reform of the deposit insurance system. However, the presence of measurement error, a practical certainty in any attempt to report thrift assets and liabilities at their market values, will inhibit the judicious closing of thrifts when their net worth is zero. In addition, such closings are certain to be challenged in the courts by thrift owners and other stakeholders in an effort to preserve their property rights, and the courts will not necessarily agree with the insurers. Finally, such litigation might require a significant expenditure of resources by the insurers or the thrift owners, resources that could be better used in other capacities.

In today's environment Kane's proposals represent only modest changes for a system that needs major restructuring. If Professor Kane were writing this monograph today, he would likely offer sweeping changes in the overall form and structure of the nation's deposit insurance program, including a discussion of how the transition to the new structure should be managed. This transition issue will certainly be a key component in any major reform proposal.

The Gathering Crisis in Deposit Insurance is an important volume for academic scholars, policymakers, practitioners, and others interested in the overall safety and soundness of our financial system. If the finance community is lucky, Professor Kane will publish a new volume dealing with the question of where we go from here.

William Curt Hunter

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Notes

[1] In addition to providing much-needed assistance to the thrift insurance fund, the law also requires banks to clear customers' checks more quickly, bans the creation of new limited-service (nonbank) banks, and imposes a moratorium on granting banks authority to expand into such areas as insurance, real estate, and securities underwriting.

[2] William Proxmire, "Comment," *American Banker*, September 23, 1988, 4.

[3] R. Dan Brumbaugh, Jr., and Robert E. Litan, "Insuring the Insurers: The Banks Are in Big Trouble, Too," *The New York Times*, Sunday, August 21, 1988, sec. 3.

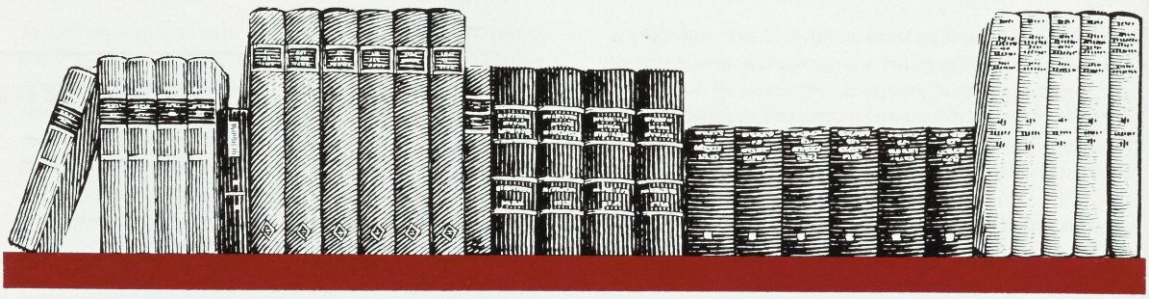
Book Review

The Netherlands and the Gold Standard, 1931-1936: A Study in Policy Formation and Policy

Edited by Richard T. Griffiths.
Amsterdam: Nederlandsch Economisch-Historisch Archief, 1987.
214 pages. $37.50.

The Gold Standard and the International Monetary System 1900-1939

by Ian M. Drummond.
London: Macmillan Education Ltd., 1987.
71 pages. $9.95.



Persuasive evidence for old debates often comes in unexpected forms. Such is the case with *The Netherlands and the Gold Standard, 1931-1936.* The debate concerns the stability usually associated with a gold-backed currency: does the stability result from the gold standard, or is such stability a prerequisite for the maintenance of the standard? Although not the editor's main purpose, this book provides substantial evidence that it is the stability that permits the gold standard; gold does not by itself provide that stability.

By 1931 the gold standard, under which a nation's currency can be converted into fixed amounts of the precious metal, had unraveled in most countries, with the notable exceptions of the Netherlands, France, Belgium, and Switzerland: the "gold bloc" countries. Of these four nations, the Netherlands was the last to come off the gold standard; it did so, reluctantly, in 1936.

The Netherlands and the Gold Standard, 1931-1936 helps explain how this country abandoned its gold-based currency. The book contains nine chapters, each of which reports on the events of the period through the experience of different groups; for example, Chapter 3 is titled "The Employers Association," Chapter 4, "The Agricultural Lobby," Chapter 5, "The Trade Unions," and so on. Like a multiperspective novel, the chapters in this collection tend to recount the same basic events as seen by a variety of interested parties. Given its rather narrow topic, this book would not seem particularly interesting, no matter how good a job the authors or editor did. The story that emerges, however, should be read by everyone interested in the feasibility of a gold standard.

Griffith's collection of essays correctly portrays the early 1930s as a time of world economic instability. Though the rest of the world seemed to be devaluing—that is, moving off the gold standard—from this text one gathers that the people of the Netherlands simply did not want to abandon gold; even groups that would benefit the most from a devaluation did not contend

that the gold standard was undesirable. Rather, their arguments seemed purely pragmatic and somewhat apologetic, essentially professing the merit of the gold standard while acknowledging that they would be better off without it. Those people with little to gain from devaluation strongly opposed it, of course. In short, maintaining a gold standard seemed to be a politically safe, if not indeed popular, position, which helps explain why the Netherlands held on for so long.

Eventually, though, the Dutch were forced to let go. Devaluations by other countries lowered the value of the Netherlands' foreign-exchange holdings; as a result, whenever another country devalued, a speculative run on the Dutch currency would take place. Beginning in March 1935, the "gold bloc" countries started to abandon the precious metal, intensifying pressures on the remaining gold-standard bearers. After France devalued, Switzerland and then the Netherlands had little choice but to follow suit. Even though a reasonable political consensus existed to retain the gold standard, international instability overwhelmed domestic desires. In such an environment, the gold standard simply was not feasible.

The authors did not set out to make this point, however. Instead, they produced a text aimed at understanding the devaluation decision itself and the reasons it did not occur earlier. To this end the book represents a remarkable effort in reconstructing the political forces and economic conditions of the time. Unfortunately, the very narrow scope of the inquiry and the quite detailed result could easily deter most readers. This effect is regrettable, for the underlying moral of the Netherlands' story is quite relevant to some of today's debates. Despite its political popularity, the fate of the gold standard was determined by world instability.

Ian Drummond's *The Gold Standard and the International Monetary System 1900-1939* addresses the question in quite a different manner. Containing just 49 pages of text, the work is overwhelmingly brief. In addition, the style and tone of writing are similar to a personal letter's, with the end result being a book that is a quick and easy read.

Drummond divides his exposition into three time periods and a summary. The first part of his narrative covers the years from 1900 through the beginning of World War I. Presented in this section is a brief overview of the gold standard's mechanics in an essentially tranquil period.

Chapter 2 reviews the activities from 1914 through 1931. The First World War took nations off the gold standard; after the hostilities ended, many countries tried, with varying degrees of success, to get back on it. With the exception of the "gold bloc" countries that held out a few years longer, these attempts ultimately failed, particularly under the pressures of the Depression. Only 16 pages of Drummond's work are devoted to this period, and so many of the interesting developments—such as reparations payments and some hyperinflations—are ignored.

The final chapter of *The Gold Standard and the International Monetary System 1900-1939* charts the remnants of the gold standard during the Depression and the immediate consequences, particularly in Europe, of at least somewhat floating exchange rates.

Drummond's book may be useful for undergraduates who want a quick understanding of the actual workings of a gold standard during the prewar twentieth century. Though this monograph presents only superficial historical coverage, in certain circumstances that focus (or lack thereof) is a virtue rather than a defect.

The gold standard will no doubt look progressively more attractive as time passes and as people forget why the standard was abandoned. Drummond's book offers just a quick recapitulation of the workings and failings of gold-backed money. The story of the Netherlands, though, with its well-meaning people who would have collectively preferred the gold standard only to have their desires dashed by international instability, is worthy of an occasional recounting whenever the luster of gold grows bright.

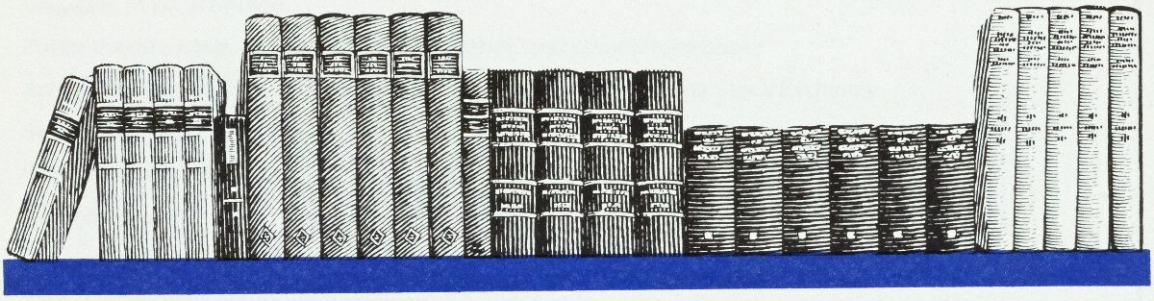
Thomas J. Cunningham

The reviewer is an economist in the macropolicy section of the Atlanta Fed's Research Department. This review appears in a somewhat different form in the Spring 1989 Journal of Economic History.

Book Review

Migration and Residential Mobility in the United States

by Larry Long
New York: Russell Sage Foundation, 1988.
416 pages. $39.95.



As migration transforms the demographics of a region, its economic and social features shift as well: the education, experience, or number of workers might be altered, thus changing the nature of a local work force. Also, the different saving and spending habits of a new population can significantly modify an area's financial and consumer markets. Research that attempts to quantify migration's impacts can thus be helpful in many different arenas.

One recent contribution to the literature is *Migration and Residential Mobility in the United States* by Larry Long. The publisher's news release heralds this study as "a comprehensive interpretation of the last half century of Americans-in-motion." The publicist's claim notwithstanding, Long's stated goal is less ambitious: to integrate and communicate the trends and patterns of geographical mobility within the United States. His overview of migration revolves around the answers to seemingly simple questions such as *who, where, how much, why,* and *with what effect.*

Long's monograph succeeds most when the migration picture is clear, that is, when the *who, where,* and *how much* questions can be answered with precise and consistent data. The author is at his best in giving an overall numerical perspective and describing what has and has not changed, as measured by national censuses and surveys, over the last 50 years. That he does this well will come as no surprise to migration researchers, since Long is a well-known and highly respected scholar at the Center for Demographic Studies of the U.S. Bureau of the Census. His prolific research is further evinced in the fact that 20 of his own journal articles are cited among the bibliographic entries.

The author also succeeds in pointing out where the migration picture is blurred, that is, where our understanding of the basic determinants and consequences of migration remains incomplete. The obscurity here emerges as Long seeks answers to the *why* and *with what effect* questions about migration. Because these knowledge gaps limit the policy implications that can be inferred authoritatively, Long's contribution is less in the realm of policy prescriptions, which are few and tentative, than in identifying many of the gaps in our understanding of migration's causes and socioeconomic effects.

Following an introduction to the available migration research and data, Long's tome investigates how much geographical mobility has occurred within the United States over short

and long distances, as well as how levels and rates have changed not only recently but also over extended periods. His discussion focuses primarily on the degree of migration between states. Thus, major interstate population movements—where migrants come from and where they go—are identified, and issues including the extent and likelihood of return and repeat interstate migration are explored. Numbers abound in these chapters, although Long presents the data effectively, using visual aids such as maps that are shaded to reflect data or that depict migration streams with arrows.

Among the major movements chronicled in Long's maps, graphs, charts, and tables are the 1930's exodus from the Dustbowl states, the migration of many New Yorkers to the New Jersey suburbs and Florida beaches, and the parade of migrants to California. He also notes many shifting migration patterns of the last half-century, particularly the pre-1970's South-to-North stream that since has experienced a dramatic reversal.

Several of the migration trends that Long discusses were unanticipated when they occurred, and others probably will surprise readers even in retrospect. It is fairly well known, for example, that blacks reversed their net out-migration from the South during the 1970s and several heavily industrialized northern states that compose the Rustbelt lost population to migration during the last decade. Long also presents three findings that will prove novel to most readers: (1) northeastern and midwestern states that experienced net out-migration in the 1970s typically had below-average rates of out-migration among persons at prime migration ages; (2) high-growth states in the West and South typically have had above-average rates of both in-migration *and* out-migration; and (3) the propensity to leave one's state of birth was lower in the late 1970s—when the baby boom began moving through adulthood—than in the late 1950s, a time popularly portrayed as one of stability.

Of course, many of Long's findings are hardly surprising. The notion that "migration begets migration"—that people who move are more likely to move again or that large numbers of in-migrants may increase the mobility potential of nonmigrants—jibes with intuition. Also, his discovery that the incidence of long-distance moving has increased might be expected from certain important developments like post-World War II improvements to the nation's transportation and communications networks, industrial decentralization, and the growing importance of a widely dispersed service sector.

The early chapters also provide some items to interest trivia buffs, although the examples cited here are more than trivial. The reader is informed, for example, that the largest county in the 48 contiguous states is San Bernadino, California, with more than 20,000 square miles, and the smallest is the two-square-mile Washington, D.C., suburb of Falls Church City, Virginia. This type of information is not mere minutiae, though, since Long uses such tidbits to illustrate key points. The "large county-small county" example illustrates an obvious limitation of presenting internal U.S. migration statistics on a county basis. A family in San Bernadino can move 120 miles and not change counties, but a move of a few blocks may entail a change in county residence in the suburbs of the nation's capital.

Chapters 5-7 explore the reasons for and the consequences of migration. The first of these chapters considers the impacts of migration, especially at the regional level. The racial composition of migration streams is addressed, as are some effects of population movements on the levels of education and poverty. Generally, the net effect of migration on the South has been an improvement in its socioeconomic standing relative to the rest of the nation. Chapter 6 considers migration from a metropolitan-nonmetropolitan perspective. Interest in this topic has intensified over the last decade and a half, partly because movement between urban, suburban, and rural areas provided researchers with another migration surprise. From the late 1960s through the 1970s migrants' preferences shifted from favoring metropolitan to nonmetropolitan locales, but around 1980 metropolitan areas experienced a resurgence. Chapter 7 examines the reasons that people give for moving. Long points out the shortcomings of inferring migration's determinants by querying individuals: for example, they simply may not know their motives, or may have reasons for misrepresenting them. Nonetheless, he provides some justification for this methodology by indicating the drawbacks of determining the

motives for moving solely from observed migratory flows. For example, the reasons for retirees' migrating cannot truly be identified and compared except through personal interviews.

In the book's last chapter, Long analyzes international census and survey statistics in order to compare migration in different nations. From this vantage, the author poses a number of important policy questions:

- Do state welfare benefit levels stimulate or inhibit migration?
- Should public policy attempt to influence mobility of the unemployed or low-income persons and families by directly subsidizing migration?
- Is national economic growth constrained by worker reluctance to move in response to industrial restructuring?
- Do national policies regarding home ownership and financing restrict mobility?
- Is greater mobility increasing the need for social services, such as care of elderly people that relatives living nearby would otherwise provide?
- Should the U.S. government enact "place" policies to increase economic opportunities in some areas or "worker" policies to increase mobility toward areas with growing employment opportunities?

Answers to these questions rely on a much more detailed understanding of the causes and consequences of migration than is now available. Research to help define the factors that motivate migration must still be done. It is critical to know, for example, whether economic or noneconomic influences are migration's primary determinants and whether the reasons for moving have changed over the decades. Answers to the causality question will be found only in a properly constructed model that incorporates economic features such as employment opportunities as well as noneconomic influences such as climate, amenities, or quality of life.

Long considers the data on reasons for moving and concludes that life-style amenities play a strong subordinate role in motivating migration, though there is little evidence that they have superseded economic motivation. He also concludes that "there is no firm evidence for or against the widespread notion that reasons for moving have changed over the last several decades in favor of noneconomic motives like a desire to live where the weather is nice, where recreational opportunities are present (whether mountains for skiing or beaches for surfing), or where other quality-of-life amenities exist."

Long does not review in detail the voluminous economics literature relating to migration, but he cites major research contributions, provides relevant bibliographical information, and ably summarizes the strengths and shortcomings of "traditional econometric models." Most importantly, he recognizes that a variety of age, period, and cohort effects influence migration propensities. The author also seems to agree that for theory development a more extensive use of both macroeconomic analyses of migration and microdata is necessary.

These exercises are not carried out in Long's book, but to ignore the work because of its lack of detailed econometric findings by others or statistical analyses based on the author's own work would be a mistake. Rather, economists interested in understanding the *why* and *with what effects* questions surrounding migration will find that this monograph provides valuable, if not essential, background material. (The book contains a wealth of data in tables and appendices for readers who want to review the statistics.)

The *with what effect* question actually has many aspects. Long writes, "[The question] can refer to the effects of migration on places, on people (those who do not migrate as well as those who do), and on more abstract concepts, such as occupational mobility of the labor force, the care of elderly persons whose children have moved away, and the nature of participatory democracy and the role of voluntary activities in a society where individuals' commitment is to career and its advancement through migration rather than to places." Several aspects of this question are inherently complex. Moreover, the census data and the survey information that Long has chosen are not suitable for addressing many of these difficult impact issues. Thus, his concentration on migrants' characteristics and the effects of migration on places is not surprising.

Migration and Residential Mobility in the United States is one in a series of analyses aimed at condensing and analyzing the vast statistical results of the 1980 census. Topics in the series explore major features of our society—ethnic groups (blacks, Hispanics, foreign-born); spatial dimensions (migration, neighborhoods, housing, regional and metropolitan growth and decline); and status groups (income levels, families and households, women). The studies, constituting "The Population of the United States in the 1980s," were planned, commissioned, and monitored by the National Committee for Research on the 1980 Census; this committee was formed by the Social Science Research Council and is sponsored by the council, the Russell Sage Foundation, and the Alfred P. Sloan Foundation, with the collaboration of the U.S. Bureau of the Census. The ultimate objective of the committee and its sponsors has been to produce "a definitive, accurate, and comprehensive picture of U.S. population in the 1980s." Long's monograph represents an important contribution to the studies and surely will be a valuable reference work for researchers in this field.

William J. Kahley

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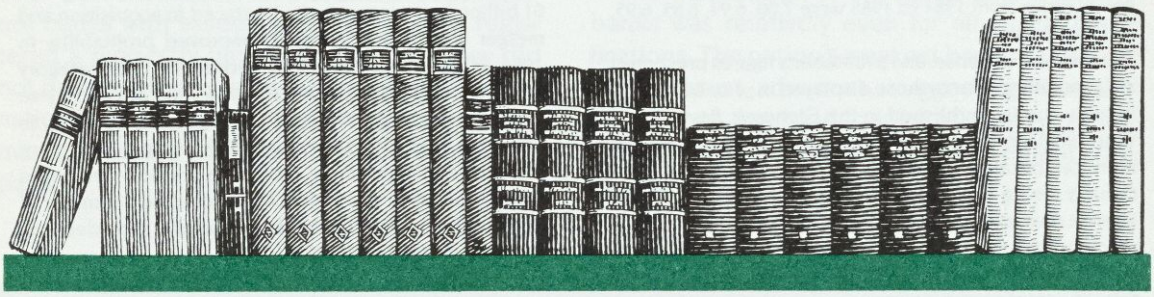
Book Review

Memoirs of an Unregulated Economist

by George J. Stigler.
New York: Basic Books, 1988.
228 pages. $17.95.



George Stigler has made seminal contributions in an uncommonly broad range of areas in the field of economics, including economic history, price theory, and industrial organization. In each of these areas, his inventive analysis has established whole new approaches to studying economics. He adapted, enhanced, and applied existing price theory to a rich and varied array of real world situations.

Stigler's early work in the history of economic thought analyzed the writings and research of David Ricardo, John Stuart Mill, David Hume, and William Stanley Jevons. Later, he delved into such issues as the concept of originality. He argued that intellectual originality is not a matter of who first conceives an idea but of who first makes it important.

Although he focused originally on studies of economic history, Stigler's contributions in applied economic analysis have been fruitful throughout his career as well. In the fields of industrial organization and the economics of regulation, his work has had a measurable impact on public policy and on perceptions of the appropriate scope to government's role in the marketplace. In particular, his studies regarding the economics of information—which treated information as a scarce, and therefore not free, resource—have been applied to analyses of advertising, the labor market, and business cycles.

Professor Stigler, now director of the Center for the Study of the Economy and the State at the University of Chicago, has a formidable reputation for using humor and humanism, which, in concert with acute and serious analysis, have made his writings on economics some of the most elegant in the history of the profession.

The tone of Stigler's *Memoirs of an Unregulated Economist* is playful, reflecting the author's definition of humor as "the ability to see oneself with detached candor." The issues discussed in these reminiscences are uniformly serious, and many of them, in fact, remain unresolved. However, Stigler's "detached candor" succeeds in communicating the excitement of first-class minds grappling with puzzles and makes accessible the economic concepts providing the inspiration. Despite his witty approach, however, Stigler does not minimize the real struggle and contention that accompany the clash of ideas.

Two themes run through these stylish and gentle memoirs. The first of the book's major topics is general enough to be familiar to anyone who engages in purposeful problem solving:

Ideas, and the people who develop them, evolve through exposure to different facts and a variety of opinions. Much of this book relates episodes in Professor Stigler's distinguished career that show how his perceptions of important economic concepts and public policy issues changed at various times. These shifts in thinking resulted from his own work as well as the persuasiveness of others' discoveries.

Stigler points out that some of this century's major contributions to economics owe their preeminence, temporary or ongoing, to the support of economists who opposed them at one time. He himself has sometimes led the profession but at other times has been carried along with the majority of his colleagues. For instance, in 1950 Professor Stigler, together with most analysts of industrial organization, believed that monopoly posed a major public policy problem in the United States and that it should be dealt with by breaking up dominant firms. Stigler admits that at that time, when the presence of industrial concentration was accepted as evidence of noncompetitive behavior, this belief was based "more upon consensus than upon evidence." As the 1950s progressed and both empirical and theoretical economists failed to certify that concentration necessarily compromised competition, Professor Stigler and the economics profession moved away from the earlier position.

The second major motif in Stigler's reflections is the generality and richness of economic analysis. The tools of the economist are the assumption of rationality and its persistent application to all decision making. *Memoirs of an Unregulated Economist* recounts recurrent patterns of mistaken though widely accepted ideas' eventually succumbing to the relentless application of economic reasoning. In this way the two major themes of the book are united.

Many anecdotes throughout the memoirs highlight two critical aspects of the process of idea development that are essential to intellectual progress: openness and the stringent empirical testing of results. Marshall Breger described the evolution of ideas as a procedure that "requires the frank expression of divergent views, even if tentative and not fully informed; the testing of views through critical queries, even if put forth only for the purpose of debate; and the raising of alternatives for discussion, even though one may not necessarily favor them."[1] Professor Stigler has been fortunate to have worked in several settings, including the National Bureau of Economic Research (NBER) and the University of Chicago department of economics, where this process was followed with great enthusiasm and to quite productive ends.

During Stigler's career a number of previously accepted truths were discredited through adherence to this process, yet persistent problems of economics, especially in the realm of economic policy, are still not entirely provable or completely refutable; many, though, are subject to empirical testing. Professor Stigler relates how his colleagues at the NBER, as well as the goals of his own research agenda, impressed upon him a respect for the power of empirical data in evaluating economic theory. Over the span of Stigler's career, members of his profession made enormous progress in developing techniques to infer information from data. However, even many defunct theories and "facts" have had some (possibly spurious) empirical basis. Thus, Stigler demonstrates that the evolution of ideas is a risky process, in which the new outcome is not always closer to the truth than the previous "facts."

A review of the accomplishments of an economist as eminent as Stigler—who received the Nobel prize in 1982—reveals a healthy skepticism that acknowledges the pitfalls and weaknesses of his chosen profession. Although such an attitude may recognize the limitations of specific research, it does not extend to acknowledging any real boundaries to the scope of economic analysis. "Of all the social scientists, only economists possess a theoretical system to explain social behavior . . . ," Stigler writes. Furthermore, "the very nature of economic logic invites a sweepingly wider application of economic analysis to social phenomena. An economic problem is a problem of choosing efficiently among alternative ways to use resources, whether the resources are dollars, a bowl of whipped cream, available time, or even a reputation for honesty and skill. . . . [E]conomic logic is the logic of all efficient behavior." As economics has invaded other fields—sociology, law, studies of both discrimination and childbearing, and so forth—the discipline has elicited some hostility because of the dispassionate

manner in which it approaches issues "loaded with emotional commitments." Yet policy-making, Stigler believes, must be informed by the rigorous analysis of a measure's costs and benefits, both financial and intangible. Professor Stigler was one of the pioneers in this rich vein of economic policy research.

Unfortunately, even though economic analysis can address an immense variety of problems, courtroom decisions have often failed to recognize the worth of its application. Sprinkled throughout these memoirs are examples of how the less efficient and possibly irrational legal process triumphed over economic ideas in some cases in which Professor Stigler was involved. To be right is not necessarily to succeed. Perhaps economic analysis' hubris invites these results.

Overall, *Memoirs of an Unregulated Economist* is gracefully balanced between a discussion of ideas and an informal history of the people who have argued for and against them. At times, however, there is a distinct incongruity between the affectionate, chatty observations about famous colleagues, which can be fully appreciated only by those acquainted with their contributions to the profession, and the offhand, breezy descriptions of the advanced economic concepts these people developed. Anyone familiar enough with the economic literature to enjoy Stigler's personal insights may be unsatisfied by his oversimplified treatment of the economic issues. Similarly, readers who require an introductory-level discussion to the issues will be unenlightened, even baffled, by the intimate but prosaic insights into such great economists as Frank Knight, Jacob Viner, Milton Friedman, and Aaron Director—all teachers or colleagues of Professor Stigler. For example, the discussions of economic externalities and rational expectations are barely motivated and serve more to provide insight into personalities than to illustrate the progress of economic analysis. This drawback is unfortunate because Professor Stigler's significant contributions to economic analysis suggest he is uncommonly well equipped to make his memoirs useful to students of both economic issues and the history of thought.

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Note

[1]Marshall Breger, "Sunshine Act: Decade of Exposure Leaves Wrinkles," *Wall Street Journal*, September 25, 1986, 30.

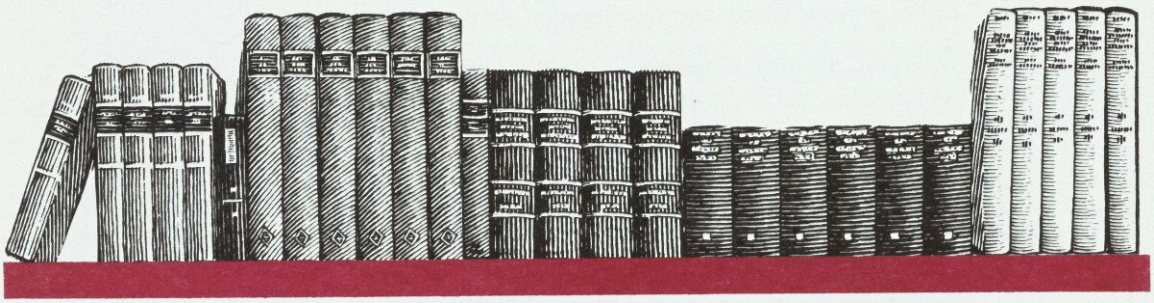
Book Review

Breaking Up the Bank: Rethinking an Industry under Seige

by Lowell L. Bryan.
Homewood, Ill.: Dow Jones-Irwin, 1988.
209 pages. $42.50.

Breaking the Bank: The Decline of BankAmerica

by Gary Hector.
Boston: Little, Brown, 1988.
363 pages. $18.95.



It is tempting to argue that Gary Hector's *Breaking the Bank* and the first third of Lowell Bryan's *Breaking Up the Bank* tell the same story. In a detached and analytical manner befitting a senior partner at McKinsey and Company, Bryan analyzes the wrenching changes that beset American banks, particularly large ones, in the late 1970s and the 1980s; he also describes how the hangover from earlier decades of protected stability dimmed banks' vision and muddled their action. In *Breaking the Bank*, Gary Hector, a business journalist on leave from *Fortune* while writing this book, unintentionally wraps Bryan's analysis in the flesh and blood of Bank of America (B of A), describing the course the bank's management pursued through the perils encountered by most banks, large and small, during the seventies and eighties. Arguably, B of A's unusual circumstances magnified the impact of many of that era's dislocations; the bank's size alone made front-page news of its problems.

From the 1930s through most of the 1970s, Bryan writes, commercial banks and thrifts in the United States operated in an insulated environment: a government insurance subsidy and markets that were often protected made it difficult for financial institutions not to make a profit, so expanding existing lines of business and undertaking new ventures were always correct strategies.

In an analysis reminiscent of many other recent accounts, Bryan explains that the 1970s brought the beginnings of economic volatility (especially in interest rates), advances in the efficiency of data communication and processing, innovations in financing techniques, and changes in the rules under which insured depository institutions operate. These developments greatly modified the nature of the markets in which banks sell their wares. With this evolution came pressure for substantial changes in the ways banks must do business in order to earn a reasonable profit and provide relatively safe and liquid deposit accounts to their customers.

Using his bank management expertise, Bryan concentrates on three aspects of the banking system that, in his view, broke up over the past two decades: (1) growth-oriented, multiproduct institutions, which had been allowed by pro-

tected markets to cross-subsidize some of their operations (without knowing the extent of subsidy to individual products); (2) banks' market share in important services such as business lending and consumer accounts, which has recently suffered major losses; and (3) a legal and regulatory system that provided an insurance subsidy for banks yet limited their ability to adjust to changing technology and competitive pressures.

The author argues that competition has forced banks to pay market rates on deposits, causing institutions to shift expenses away from fixed assets (branches) that had been set out to garner deposits when banks could not compete on the basis of interest payments. The largest institutions have also lost their least risky customers, who now borrow in the commercial paper market. Even the smallest banks face increased competition on both sides of their balance sheets. Bryan asserts that, in replacing lost business and meeting new competition, banks have taken on more risk without fully recognizing that they were doing so. Loans to less developed countries (LDCs) demonstrate this tendency, but Bryan contends that LDC debt is not the only risky means by which banks have tried to restore lost revenues.

Bryan concludes his analysis of banks' problems over the past two decades by describing a system that has produced bloated organizations with insufficient knowledge of their own operations to control their expenses or risk. These inefficient institutions are, according to the author, substantially aided by a government subsidy in the form of deposit insurance and significantly hindered by government regulations concerning activities and geographic dispersion.

In *Breaking the Bank,* Hector chronicles the hard times of Bank of America during an era identified by Bryan as a crucial period for U.S. banking. Hector's story of Bank of America generally ignores the economic developments that shaped events at the bank and, in doing so, limits the reader's perspective on the institution's problems. However, between the lines, the reader can discern an institution that carried Bryan's model to its "logical" extreme in a large, growing state economy where statewide branching had long been allowed. In Hector's view, B of A's large branching system, its dependence on consumer deposits, and its willingness to skimp on controls in its drive for expansion, as well as its cumbersome and sometimes ineffective bureaucracy, were particularly exaggerated.

Breaking the Bank begins with a long and fascinating paean to A.P. Giannini, Bank of America's founder. Energetic, creative, dedicated to his own business philosophy, and a prominent front-runner who remained close to his customers throughout a long, stormy career, Giannini is a fine subject for Hector's colorful style. Looking through Bryan-colored glasses, however, one may view Giannini as an entrepreneur whose innovation was to recognize and follow closely the incentives that the markets and the regulatory and insurance system presented.

Giannini's successors—including Tom Clausen and Sam Armacost—inevitably faced the kind of changes that Bryan describes and were, at first, not particularly successful in their responses. Hector upbraids these men unmercifully for running into problems that Giannini did not encounter, as well as for responding inadequately to them.

The author, however, seems to have put on blinders when he sat down to write *Breaking the Bank.* A look at annual reports of other large California banks reveals numerous similarities to B of A. Many of the problems of rising operating expenses connected with large branching systems, loan quality—especially foreign loans—and inadequate controls haunted those institutions, too.

Whether B of A's managers were less competent than the people who ran other large banks, as Hector implies and as the successful adjustment by some (but not all) large California competitors suggests, or whether B of A simply faced magnified problems is not considered by Hector; nor is the answer easily discernible. That Wells Fargo and Security Pacific, in particular, adjusted more successfully is grounds enough for Hector to disparage Bank of America. One is curious how the journalist might have written the Crocker story or might now write the First Interstate story.

Ironically, B of A has had considerable success since about the time Hector's book was published. That success, though, has not been based primarily on the plan for reorganizing banks and banking set forth by Bryan's more general and prescriptive work. In the second

and third parts of *Breaking Up the Bank*, Bryan proposes solutions for many of the problems faced by larger institutions in particular; these proposals link both private and public actions.

Bryan introduces his plan of action for banks with a discussion of structured securitized credit. His presentation of concepts, which reasonably categorizes and classifies credit functions and offers clear explanations of interrelationships, makes worthwhile reading.

Extending his argument that markets have shaved interest margins to the extent that buy-to-hold strategies will no longer be profitable for banks, Bryan proposes that credit process functions be divided into separate units. Some banks would choose to specialize in particular functions, such as funding or underwriting. Other banks, Bryan explains later in the book, would continue to perform the range of credit functions, depending on functional separation of duties within the organization for increased efficiency. In any case, funding, underwriting, credit enhancement, servicing, and various types of risk taking would be separately managed functions, adding their value and earning their way individually or in a rather loosely knit holding company.

Bryan's proposal is based on a somewhat unorthodox idea drawn from his long experience observing banks from within: banks have been induced to go into a wide variety of businesses, which has led to more complex management problems than many banks can handle. In a sense these institutions suffer from diseconomies of scope resulting from the old regulatory and deposit insurance system. These diseconomies are perpetuated by continued regulation and the ingrained complexity of managing change.

When applied, however, Bryan's advice seems to turn his analysis on its head. While smaller, less complex banks are urged to simplify, larger banks are advised to reorganize and stay together. The author encourages small banks to find a functionally limited role in the credit process and specialize. Indeed, he suggests, many small banks may find it most advantageous to join larger banks and operate as specialized deposit-gathering or lending branches. Large banks may find their niches also, but Bryan believes that many of the larger firms may be strong enough to perform all functions. For such banks the author suggests holding company organizations with functionally separate subsidiaries operating with considerable independence. Clearly, according to Bryan's advice, for many of the country's regional and money-center banks "breaking up the bank" is to be followed by putting it back together again. If smaller banks follow the suggestion that they sell out, the reorganized large banks would be even larger and more complex.

The reader may be perplexed by Bryan's advice for large banks. The author's proposals do not seem to require that structured securitized credit be adopted. Organizing on a functionally separate basis has been possible for some time, but most banks have not done so. Bryan's suggested division of functions does not seem to eliminate complexities in the interrelationships banks must manage. Rather, separating functions into more or less independent units threatens to reduce both efficiencies gained from shared costs and synergies developed from shared knowledge of company operations and goals. Moreover, separation may well reduce internal support for important but seemingly nonproductive general overhead such as interest-rate and credit risk controls, research and development, and marketing.

"... Bryan proposes that credit process functions be divided into separate units. Some banks would choose to specialize in particular functions, such as funding or underwriting."

Further, Bryan's suggestions for private action are probably much too narrow. Accepting, for the sake of argument, his diagnosis that banking is plagued by bloated and unknowing bureaucracies, it is still not clear that securitization and parallel functional division are the only ways, or even important ways, to deal with banks' problems. Bryan's proposal simply divides in a different manner the functions most banks cur-

rently perform. Whether this division is always the most efficient one is not yet clear. Bank of America, for instance, has achieved more than a modicum of success by segregating and eliminating functions in other ways. Management there has shaped the bank into an institution that more and more resembles a mega-superregional rather than a money-center bank. Securitization has played a part, but not an overwhelming one, in the transformation.

For now, all one can acknowledge is that Bryan has suggested an approach that the market has accepted for certain institutions in some situations. One can neither doubt his method's usefulness nor accept it, as Bryan appears to do, as a cure-all for private institutions' difficulties. Alternatives, like B of A's strategies for regaining efficiency, may work better in some cases.

"Whether this division is always the most efficient one is not yet clear. Bank of America, for instance, has achieved more than a modicum of success by segregating and eliminating functions in other ways."

The public policies Bryan proposes for the banking system would give banks the flexibility to adapt to the changing order, particularly through securitization. Bryan's suggestions range from technical amendments to bankruptcy laws and Securities and Exchange Commission (SEC) rules to changes in bank powers, capital requirements, and accounting rules.

Bryan acknowledges the necessity for much of the nation's rather complex bank regulatory network: depositors and the financial system both must be protected from risk. He argues, though, that depositor and systemic risk protection need extend only to demand deposits and other consumer and small business deposits in order to provide sufficient safeguards.

To achieve these safeguards, Bryan advances a version of the narrow bank, a concept most often associated with Robert Litan's 1987 book, *What Should Banks Do?* Issuing only a limited variety of deposits and holding only low-risk assets, institutions of this type would protect the nation's transactions deposits and payments system. Other financial institutions, functionally (and presumably less intensively) supervised and regulated, would make and securitize loans funded as needed by uninsured deposits or any other instrument the market would accept. This arrangement could rid the system of many of the inhibiting and costly regulations that now burden it, and each institution could seek its niche(s).

The arguments of narrow bank proponents have not been enthusiastically embraced by bankers or politicians. In its favor, the narrow bank draws an unambiguous line between bank activities that are insured and those that are not. If the public believes that the line is fixed, the public will follow incentives to monitor the condition of institutions offering uninsured assets and thus help to limit risk. Since credit risk in the narrow bank is limited by the assets it can hold, such an institution addresses Bryan's concern for the safety of demand and other small deposits. The narrow bank concept also allows the regulation of the rest of the system to be reduced, thus permitting more flexibility to institutions in general.

The author's plan, however, would let holding companies that own narrow banks own other financial institutions also. The plan relies on "firewalls" to separate the risks of safe, narrow banks from those of riskier institutions. The efficacy of these firewalls is doubtful, though. Bank regulators already look to the holding company, and by implication its subsidiaries, as a source of financial strength to individual bank entities, particularly if such strength will save public funds. For this reason and others, the public may perceive risk even in a narrow bank when its parent or siblings have trouble. Further, even in a system with narrow banks, large institutions may require rescue in order to protect credit and payment flows.

As do many other narrow bank proposals, Bryan's leaves several questions unanswered: Are there enough safe assets to back the narrow banks' safe liabilities? How would interest-rate risk be addressed? Would narrow banks need a subsidy to operate profitably? Can such a subsidy be justified on the basis of the public

benefits of safe transactions deposits? Would important economies of scope be lost in the separation of transactions deposits and safe investment functions from other typical banking functions? Is protection of money alone sufficient? Could interruption of credit flows (eliminated from the narrow bank by definition) be the key danger brought to the economy by systemic failure?

Bryan's suggestion for private action by banks might also have negative public impacts. His proposed reorganization would result in fewer, larger banks, he believes. Diversification gains have their limits, however, and significant public fear exists that large financial institutions may fold. Bryan himself contends that even today the failure of a large nondepository financial institution, such as a large investment bank, would require government intervention. Under his system, with larger institutions such intercession may be even more likely. Pressure to extend government insurance coverage beyond the narrow bank, whether de facto or de jure, would likely occur under Bryan's system.

All in all, both Bryan and Hector write worthwhile but incomplete books. Bryan contributes eyes- and hands-on experience in bank management and a useful explanation of securitization to the public discussion of banking problems and their solutions. Hector's narrow focus and his admiration for Mr. Giannini lead him to flagellate latter-day Bank of America managers for being in the wrong place at the wrong time, but *Breaking the Bank* offers a colorful tale and a between-the-lines case study of Bryan's abstractions. Both books should aid our understanding of the complexities involved in solving a set of problems that has developed over several decades. Each book, in its own way, underlines the difficulties of reforming private institutions and public policy on the fly and warns against simple solutions.

B. Frank King and Sheila L. Tschinkel

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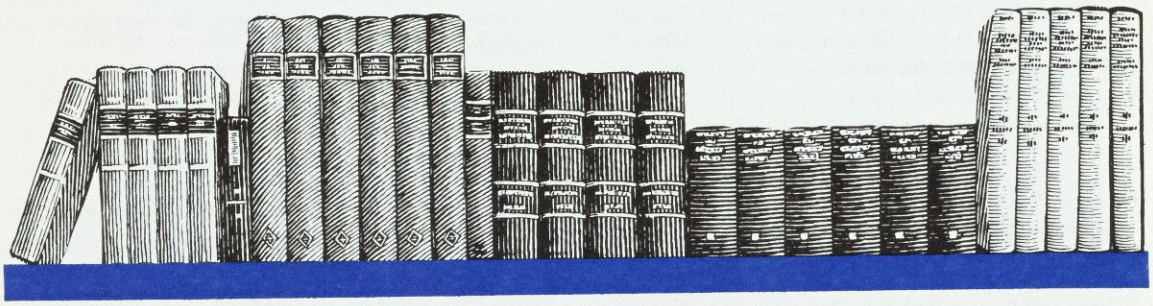
Book Review

Bank Costs, Structure, and Performance

by James Kolari and Asghar Zardkoohi.
Lexington, Mass.: D.C. Heath, 1987.
240 pages. $29.00.



Changes in banking regulations in recent years have created new opportunities for commercial banks and other financial institutions to expand their operations. Restrictions on interstate banking and intrastate branching have been liberalized in many states. In addition, legislators and regulators have relaxed many limitations formerly constraining the types of services financial institutions could offer. Along with these developments, though, have come new questions about the future structure of the financial services industry. The industry's composition will depend to a great extent on the types of financial institutions that can remain profitable over time, and profitability will be determined largely by the extent to which banks achieve production economies and resultant cost reductions while expanding their operations.

Two types of production economies are generally available to banks—economies of scale and economies of scope. Economies of scale exist if average production costs decline as output increases. Scope economies are present if two or more products can be jointly produced at a lower cost than is incurred in their independent production. In some industries, such as utilities, it is efficient for a single firm to supply the entire industry output. These industries are termed *natural monopolies* and are characterized by economies of scale at every output level consumers are likely to demand. Recent empirical evidence suggests that the conditions sufficient for natural monopoly in banking are not satisfied over the relevant range of output. Rather, overall economies of scale appear to exist only at low levels of output, and diseconomies, at large output levels, suggesting a U-shaped cost curve for the industry.[1]

Against this backdrop, James Kolari and Asghar Zardkoohi—professors of economics and public policy, respectively, at Texas A&M University—undertake an important and timely task. *Bank Costs, Structure, and Performance* provides a good introduction to the topic of cost economics in banking and an in-depth review of the pre-1985 literature on production economies. The authors reexamine the issue of scope economies in banking and introduce a new measure designed to estimate the extent of these economies. In contrast to past research on bank costs, Kolari and Zardkoohi perform separate analyses (using 1979-83 data) for banks with differing market (product) characteristics. Unfortunately, the researchers fail to emphasize the qualified nature of the evidence they use to

draw some of their major conclusions and policy implications. In particular, their cost complementarity and scope economy results should be interpreted with caution. Allen N. Berger addresses these and other shortcomings in another, earlier analysis of Kolari and Zardkoohi's work.[2]

In the first chapter, Kolari and Zardkoohi set the stage for their discussion of costs by describing the external and internal pressures on banking that continue to affect bank profits: increased competition from nonbank institutions, the spread of interstate banking, product line deregulation, and the rapid pace of technological advancement in the industry. These developments have brought about a more competitive environment in which banks must operate as efficiently as possible. The authors' historical overview of twentieth-century banking leads them to suggest that legal and regulatory changes have greatly influenced the structure of U.S. banking. Deregulation has already pushed banks to become more efficient, but its lasting effects cannot be foreseen without some idea of how bank costs behave.

Kolari and Zardkoohi begin their study of bank costs with a review of microeconomic production theory and how it may be applied to the special problems of banks. The authors also delineate sources of scale and scope economies and describe how these are measured. In their discussion of conceptual and methodological issues that arise in estimating such economies, Kolari and Zardkoohi find that the appropriate definition of bank output and choice of functional form are especially important. Accurate measurement of bank output is necessary because economies of scale are defined in terms of the volume of the bank's output.

The researchers analyze the choice of output measure and conclude that dollar values of loans and deposits, rather than number of accounts, should be used. Their argument is that "banks compete to increase market share of dollar amounts as opposed to the number of accounts . . . [and] in a competitive banking environment the cost of an additional dollar of both small and large accounts should be the same." Specification of the functional form of the cost function (and therefore the underlying production function) is also closely related to the measurement of scale and scope effects. The production function identifies the relationship between the quantities of output that result from the use of various quantities of inputs. Comparing three economic production functions—the Cobb-Douglas, constant elasticity of substitution, and translog functions—the authors assert that the last is the preferred form. It is flexible enough to yield U-shaped cost curves (diseconomies as well as economies of scale and scope) and it allows for banks' characteristic multiple inputs and outputs.[3]

Chapter 3 presents a comprehensive survey of previous literature on bank costs, divided into three parts: (1) early studies that relied on simple financial ratios to calculate bank costs, (2) analyses from the mid-1960s and the 1970s that used the Cobb-Douglas function and specified only one output, and (3) more recent works that focus on the translog function. Notwithstanding the various studies' differences in methodologies, output definitions, and data sources, Kolari and Zardkoohi conclude from a review of the earlier studies that "small banks were at a cost disadvantage compared to large banks but that the difference was not so large as to prevent them from competing effectively. . . ." Recent research using the translog cost model yielded results somewhat contrary to those obtained earlier: very small banks were found to be cost-efficient for the most part. All of the studies indicate that most scale economies are exhausted when bank size reaches about $25 million in deposits and that diseconomies of scale exist at large output levels, leading to the familiar U-shaped cost function. However, the evidence on scope economies was ambiguous. Even studies that found positive evidence in favor of joint production concluded that scope benefits were not substantial enough to alter the scale results.

In chapter 4 Kolari and Zardkoohi present the econometric results of their own research. Using Federal Reserve Functional Cost Analysis (FCA) data for 1979-83, they estimate three models: (1) demand deposits and time deposits, (2) loans and securities, and (3) loans and deposits.[4] The dependent variables are the allocated costs for the specific outputs appearing in each regression model. The two researchers find average cost curves to be relatively flat in most cases, so scale is apparently not an important cost deter-

minant. The major implication of a flat cost curve is that many different sizes of banks should be able to coexist. The authors perform jointness tests and find that significant cost complementarities exist only in the joint production of loans and deposits. Kolari and Zardkoohi also use their new measure of scope economies, which gauges the decrease in costs from producing output jointly, as compared to expanding total output by increasing each of the bank's products one at a time (from the minimum level for banks of about the same size). On average, Kolari and Zardkoohi find that banks can reduce expansion costs about 30 percent to 50 percent by increasing outputs at the same time, as opposed to increasing each output separately.

Several issues and problems, both conceptual and methodological, may have influenced the results reported in chapter 4. As a consequence, the usefulness of Kolari and Zardkoohi's conclusions in drawing policy implications, although not eliminated, is limited. First, the FCA data used in the analysis are heavily skewed toward small banks. As of 1986, only 490 banks participated in the program; of this number, 416 held under $200 million in total deposits. To draw conclusions about the cost structure of large banks (over $1 billion in total deposits) based on FCA data is not meaningful and can be misleading. Also, the FCA procedures for allocating costs are sometimes imprecise and may induce bias in the results.

A second problem that may distort the results is that Kolari and Zardkoohi exclude interest payments from their cost measure. Berger, Gerald A. Hanweck, and David B. Humphrey (1987) have shown that studies using dollar measures of outputs and total operating costs as the dependent variable are biased toward finding scale economies because banks can fund a larger asset portfolio by increasing purchased funds. Thus, Kolari and Zardkoohi's analysis is biased by a bank's choice to gather deposits through a branching network or to purchase funds from other retail banks.

A third problem arises with interpreting the authors' cost complementarity and scope economy results. When the results from the translog cost function are used, a *necessary* condition for the existence of cost complementarity between two products is that their cross-product term (δ_{12}) be negative and statistically different from zero. A *sufficient* condition for cost complementarity requires that their cross-product term be not only negative but also greater in absolute value than the product of their output elasticities.[5] However, the cross-product terms reported by Kolari and Zardkoohi are positive in most cases, suggesting that cost complementarity does not hold or, if it does, that negative estimated marginal costs are generating it. Since the authors do not provide the level of complementarities or the estimated marginal costs, it is impossible to determine which condition exists.[6] The fact that Kolari and Zardkoohi do not investigate the scope economy results for statistical significance further detracts from their results.

In chapter 5 the authors test the hypothesis that differences in product mix influence bank cost structures. Based on balance sheet ratios, banks are clustered into four types: farm, retail, city, and wholesale. Only farm banks were found to have unique cost characteristics. (They exhibited flat cost curves where other groups had U-shaped cost curves; they also had scope economies related to deposit size.) All four bank groups had higher scope economies in the joint production of loans and deposits than in the other two models. Kolari and Zardkoohi's results are puzzling, nonetheless. Several researchers who handled differing product mixes by specifying more outputs in the cost function have rejected the hypothesis that different asset and liability categories can be aggregated.[7] Ideally, each bank product should be included as a distinct output, but the availability of data and use of the translog functional form usually limit the level of disaggregation.[8]

Kolari and Zardkoohi turn from static costs to the impact of technological improvements in banking and how they have affected production costs. To test whether larger scale allows more cost-efficient use of technology, the authors regress demand deposit costs on the ratio of computer-related costs to labor costs and some output variables. The closer this ratio is to zero, the greater the cost savings by substituting computer technology for labor. Kolari and Zardkoohi in fact find that the coefficient lies between zero and one, suggesting that cost savings result. They find no evidence of a trend toward greater cost gains by large banks. However, whether this model is sufficiently complete to draw such a

conclusion is unclear. In particular, the authors have a very narrow view of technological change and the appropriate costs that are affected. They ignore the possibility that technological innovation can take the form of new production processes rather than equipment. Another problem with Kolari and Zardkoohi's model is that only demand deposit costs are included in the dependent variable.[9]

Finally, the authors examine the relation between cost efficiency and bank failure using Call Report data for 1984. They develop an early-warning-system model based on commonly used financial ratios and individual bank cost measures (scale economies and residual costs) generated in the research reported earlier in the book. The cost measures were found to improve the predictive power of the failure model substantially when added to financial ratios. Problems exist with the analysis, though, because Kolari and Zardkoohi fall into the trap that earlier writers did. By regressing identical operating expenses on loans and deposits separately, the authors' analysis suffers from the same drawbacks as the study by Thomas W. Gilligan and Michael Smirlock (1984): input prices are assumed to be constant and other bank services are excluded even though they affect total operating expenses. This practice gives a bias toward finding both scale and scope economies and leads them to conclude that failing banks were smaller than average.

From a policy perspective, the evidence presented in the book appears to minimize any concern that the banking industry will be dominated by a few large institutions. The lifting of restrictions on interstate banking and intrastate branching might help consolidate resources in states that have limited branch banking and thereby permit small banks to achieve a more efficient scale of production.

On the whole, *Bank Costs, Structure, and Performance* is a useful guide to future work in this area and is of interest to academicians, policymakers, and practitioners. It provides an in-depth look at the literature, introduces a new measure of scope economies, and opens some new lines of research. The book's biggest failing is the absence of necessary qualifications in regard to the econometric evidence it presents and the consequent potential to mislead readers.

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Notes

[1]See, for example, Hunter and Timme (1989) and Lawrence and Shay (1986).

[2]See Berger (1988).

[3]The main disadvantage of the Cobb-Douglas production function is that it only allows for uniform scale characteristics, while the constant elasticity of substitution function is highly restrictive in cases where firms produce more than one output or use more than one factor input.

[4]Although FCA data provide information on the number of accounts, Kolari and Zardkoohi prefer to use dollar amounts for the reasons mentioned earlier. In general, researchers take one of two approaches in defining bank costs and output: the production approach or the intermediation approach (Berger, Hanweck, and Humphrey [1987]). Under the production approach, output is measured in terms of the number of loan and deposit accounts, and costs are defined as total operating expenses exclusive of interest costs. The intermediation approach, on the other hand, measures output as the dollar value of the products offered by the bank, and costs include both interest and operating expenses. The intermediation approach uses a broader definition of costs and is considered to be more relevant for addressing issues relating to the long-run viability of banks (Hunter and Timme [1989]).

[5]See Clark (1988).

[6]Other studies (Benston et al. [1983], Mester [1987]) explicitly report negative marginal costs for some products, attributing them to estimation problems such as the presence of multicollinearity and loss of degrees of freedom.

[7]See Kim (1986) and Lawrence and Shay (1986).

[8]See Clark (1988).

[9]It is also important to note that Kolari and Zardkoohi's conclusions are limited to the smaller banks in the economy. Hunter and Timme (1986, 1988) examine the relation between technological change, production economies, and firm size for a sample of large banks and find that larger banks enjoy proportionately higher cost savings from technological change.

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