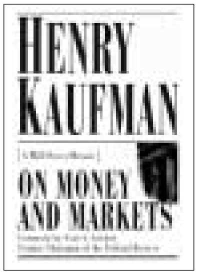
On Money and Markets: A Wall Street Memoir

By Henry Kaufman, New York, NY: McGraw-Hill, 2000, 388 pp., $24.95 hardcover.



In the mid-1970s, whenever Henry Kaufman encountered Walter Wriston, then Chairman of Citicorp, Wriston would greet the famous Wall Street bear by asking, "Is the world coming to an end yet, Henry?" To which the then chief economist of Salomon Brothers would respond, "Not as long as Citibank has access to the Fed's discount window." That interchange captures much of the flavor and the message of Kaufman's latest book, *On Money and Markets: A Wall Street Memoir*. Reflecting on a momentous career spanning a half-century, this valedictory is at once a highly personal reminiscence, a unique perspective on the vital and fragile role of financial markets in economic progress, and an engaging, and often controversial, tract for regulatory reform.

At his peak of influence in the late 1970s and early 1980s, Henry Kaufman could at times move markets more than Alan Greenspan does today. Dr. Kaufman, as he was known to those of us who worked with him in those days, only had to make one overly bearish call on interest rates to earn the sobriquet Dr. Doom. But more often than not for the better part of two decades, he was peerless in his predictions in ways that no one since has approached. For unlike other analysts whose cyclical predictions might have brought fame, Kaufman uniquely—and correctly—saw the persistent breakdown in credit restraint as a potentially dangerous *secular* source of rising interest rates and instability. While he is no longer the "unwitting pundit" for today's New Economy generation, there is much old wisdom here for students of economic history, for policymakers, and perhaps especially for traders whose only experience is with rising markets.

By his own telling, much of Kaufman's perspective draws on the hardships that he and his family endured when he was growing up. He was born to a close-knit Jewish family of butchers and cattle traders in a German farming village in 1927. He recalls vividly his first lesson in economics came from his grandfather, who recounted the story of how he was devastated financially by the great Weimar hyperinflation. As a young boy, Kaufman remembers a "menacing horde" of Nazis literally smashing down his front door as the final spur to his father's decision to flee Hitler's Germany in 1937. But life in Depression-era New York offered little immediate opportunity; and his mother went to work doing housework while his father delivered milk, both sacrificing enormously for the dream that one day their son would be a physician.

But young Henry Kaufman instead took to economics and finance, apparently inspired in part by Friedrich Hayek's *The Road to Serfdom*, which warned that economic planning would lead to totalitarianism. Henry toiled as a credit analyst by day, while working toward a Ph.D. at night, studying with Peter Drucker and Marcus Nadler, whose insights left an indelible imprint on Kaufman's thinking – namely that the drive for profits among financial institutions must be balanced with fiduciary responsibility.

From this perspective, it is easy to see why Kaufman may be "more sensitized than most native-born Americans to economic developments that might endanger this country." Thus, he was among the first to warn of the gathering inflationary clouds of the 1960s, and of the dangers of rapid debt creation in the 1970s and 1980s. He also warned of the financial excesses that accompanied wave after wave of financial deregulation, securitization, and globalization of finance throughout this period.

The chapters on financial forecasting may hold special appeal for economists. Kaufman can rightly lay claim to being a founding father of "Fedwatching," an art that once involved the close inspection of arcane factors affecting bank reserves, but now is the part-time fascination of cab drivers, hairdressers and retired dentists. Fedwatching, along with most kinds of economic analysis in Wall Street has been commoditized. However, in Kaufman's early days at Salomon, it was a ticket to stardom. His insightful analysis of credit supply and demand, and the prospective path of monetary policy, paved the way for his rise to partnership, head of research and member of the executive committee, and, ultimately, vice chairman of Salomon Inc.

No financial economist before or since comes close to the scope of influence that Kaufman enjoyed in his prime. His rise to preeminence often brought him in close contact with the top-ranking political and policy leaders of his day. The descriptions of some of those personal exchanges that occurred at pivotal moments in history will surprise and enlighten the reader. Paul Volcker, a close friend and contemporary, contributes a forward to the book; and Kaufman in turn is unsparing in his admiration for the former Fed chairman's record of leadership. Many readers will be surprised to read that Kaufman is a good deal more reserved in his judgments about Volcker's successor, Alan Greenspan.

Unlike academic economists who have diagnosed the Great Inflation of the 1965-80 period, Kaufman focuses on the role of financial deregulation. He sees the rise of "entrepreneurial finance" that began with the growing use of liability management among commercial banks in the 1960s but now entails the whole spectrum of derivatives and securitized assets, as part of the cause. Whatever other missteps monetary authorities have made, they failed to see the long-term consequences of their decisions to remove inefficiencies in credit allocation and availability. For Kaufman, while money matters, credit matters more. And, while today's financial markets are a "tribute to the triumph of capitalism," they also have fostered an "excessive zeal" among financial institutions and an overleveraging of business. Kaufman devotes considerable effort to a proposal that may seem impractical to many, for a new Board of Overseers of Major Institutions and Markets to provide a code of conduct, supervise risk taking, and harmonize capital requirements, among other reforms.

The book closes with a look to the future. But anyone who has followed the plot closely will anticipate that Kaufman sees serious risks ahead, arguing that the euphoria of recent years will be reversed. Whether or not one agrees with any or all of his prescriptions and prognostications, one cannot help but be struck by the unwavering perspective, the intellectual honesty that is rare in Wall Street, and the willingness to stand alone out of love for one's country. That passion combined with the great success he has earned has allowed Henry Kaufman and his wife Elaine to provide enormous support for educational, humanitarian, and cultural institutions. Together they define his legacy.

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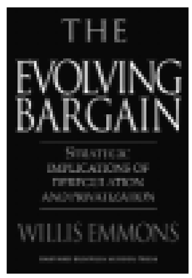
The Evolving Bargain: Strategic Implications of Deregulation and Privatization

By Willis Emmons, Boston, MA: Harvard Business School Press, 2000, 320 pp., $35.00 hardcover.

The Evolving Bargain is a book about business competition. The competition is not between firms, although there is a section about it. The competition is between the firm, the state, and all of the stakeholders that influence the outcome of deregulation and privatization.



Business economists often find it a challenge to communicate the practical uses of economics with managers and especially top management in the day-to-day operation of the organization. This book goes a long way in bridging some of that gap. It is not a cookbook that says here is what elasticity means in a practical sense, but when it discusses the necessity of "rebalancing" relative prices in accordance with market conditions, it is all there. Prior to deregulation or privatization the author notes that "enterprises often stress price uniformity, even in the presence of substantial differences in the cost of service or price sensitivity." In the chapter on transforming business operations, he notes, "the worldwide tendency of market reforms is (1) to abandon customers who are unwilling to pay the marginal cost, (2) charging higher margins to customers who place higher value on the product or who have fewer competitive alternatives, and (3) charging lower margins but increasing sales volume to customers who place a higher value on the product or enjoy greater competitive alternatives." It is almost like the beginning of an MBA lecture on converting elasticity measures to useful international business strategy.

The author has experience with MBAs. He has been a faculty member of the Harvard Business School for over a decade. However, the book is not a textbook; and it never talks down to the reader. The book is actually many interwoven case studies linking the author's insightful view of the results and strategic imperatives generated by deregulation and privatization worldwide. It is based on the author's experience and interviews of 150 industry executives, government officials, and investors. The detailed examples are from North and South America, Europe, and Asia. While it is not a textbook, it would be a valuable addition to a business-oriented microeconomics or international business class, in conjunction with the traditional economics material.

The book is nontraditional in the sense that business decisions concerning the enterprise, its competitors, suppliers and customers, are not its focus. The focus is the relation between the enterprise, competitors, suppliers, customers, other stakeholders, and the state. These relations are called the "bargain." In introducing the term " bargain", the author provides a vivid example using, "the agreement in the early 1990s where the State of Alabama agreed to provide tax breaks and infrastructure services, valued at $200 million. In return, Mercedes-Benz agreed to build a manufacturing plant with a capacity of 60,000 vehicles, employing 1,000 people." While this bargain was not in the context of deregulation or privatization, it sets the stage for numerous and more complex examples that are. Some of the "bargains" are seen to be explicit and in the form of written contracts; others are implicit and in the form of expected outcomes of the enterprise-state interrelation.

Several of the cases, although presented at a professional level, read with the excitement of a novel. In May 1991, the elections in India brought together a powerful coalition of parties having a goal of "Liberalized Economic Policy." In this context it meant that in early 1992 there could be a reform "bargain" where for the first time one hundred percent foreign ownership of electric power plants would be allowed. Enron Development Corporation, a US subsidiary of Enron Corporation, having considerable experience in other projects in Argentina, China, Guatemala, and the Philippines, organized the deal. In December 1993, a $2.85 billion agreement was signed between the Maharastra State Electric Board and the Dabhol Power Corporation (DPC). The corporation was a joint venture between Enron, General Electric, and Bechtel. The lenders were the U.S. Export-Import Bank, the Oversees Private Investment Corporation, the Industrial Development Bank, and the Bank of America. The project seemed to go smoothly and DPC negotiated a successful agreement on the project's rate of return. That is, it ran smoothly until the Congress Party was voted out of office. The new regime of the Shiv Sena and Bharatiya Janta Party (SS-BJP) had been opponents of the project. Soon after, the SS-BJP unilaterally canceled the project. DPC responded swiftly to the cancellation by initiating international arbitration proceedings, per the contract. The SS-BJP government countered with a suit in Bombay challenging the right to international arbitration, which was struck down by India's Supreme Court. In the end, DPC won the right to continue with the project but made important concessions on electricity rates. The author uses the details of the story to explain the lessons he has to teach. This one concentrates on the advantages of powerful partners, explicit contract terms, and harnessing a range of stakeholders in the process.

Not all of the cases are at the level of world affairs. An interesting example concerning implicit "bargains" involves the Yorkshire Water authority in England. Several of the implicit bargains involve the quality and efficiency of service. In this case, a severe water shortage developed in Yorkshire. The privatized water corporation was not able to respond. Several of the managerial errors are explained, including its public plea for conservation. In this regard the author's sense of humor shines by quoting the Yorkshire Water's then managing director's declaration that, "I personally haven't had a bath or shower now for three months, and nobody has noticed." The book goes on to detail the problems with the organization's public and government relations policies, and how it rebuilt its reputation.

The book is timely and virtually every page mentions organizations that are in the news. The companies include: America Online, Amazon.com, Microsoft, Yahoo, Vodaphone, Baby Bells, ATT, British Airways, National Power, Telefonos de Mexico, Rio Light, Companhia Siderurgica National, ITT, Deutsche Telcom, and WorldCom to name just a few. The list of international trade and political organizations is extensive, as well. The book will certainly help business economists, and those who use economics, to communicate with senior managers on a much more effective and informed basis.

The author details many recurring patterns. For instance, the "bargain" is both explicit and implicit. Another pattern is that prior to deregulation or privatization, expectations of benefits are often overly optimistic; and that while the projects would be considered successful on objective bases, overly high expectations detract from the results. In addition, bargains involve both rights and responsibilities on the part of both the government and the enterprise. If these bargains cannot be enforced or are unclear, the project is likely to fail. Economic events cause change, and any major loser will petition the government for redress and to recontract the agreement. A central theme is that bargains are not once-and-for-all events, and thus the book's title—*The Evolving Bargain.*

Gerald L. Musgrave
Economics America, Inc.

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- Please submit three double-spaced copies of each article. It would also be desirable to send a copy via e-mail. The author's name and affiliation should be on a cover sheet but not included directly on the article itself.

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Footnotes and references should follow the format used in the *Journal of Economic Perspectives*, a publication of the American Economic Association. For other issues of style, consult *The Chicago Manual of Style* (University of Chicago Press).

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