Milton Friedman used to emphasize that nominal interest rates are not good indicators of the stance of monetary policy, as a high nominal interest rate can indicate either monetary tightness or ease, depending on the state of inflation expectations.

Confusing low nominal interest rates with monetary ease, he argued, was the source of major problems in the 1930s and it has perhaps been a problem in Japan in recent years, as well.

What then is an adequate measure of the stance of monetary policy? There is no easy answer to this question. Money growth rate, for example, is not a good alternative. Money growth is an imperfect indicator of monetary policy because it can be substantially affected by changes in the money multiplier or changes in financial innovation. Therefore, a stable M2 – as has been the case in the US in the last 5 years – by no means denotes a constant money supply by the Fed.

Over the past decades both inflation targeting and nominal GDP became the chosen guides for conducting monetary policy. Policymakers and academics became ever more confident that inflation-targeting was the right indicator. It was argued that it captures all relevant variables – exchange rates, stock prices, housing prices and long-term bond prices – via their impact on activity and prospective inflation.

But the financial implosion of 2009 made it clear that this view is no longer plausible. The crisis showed that – when asset prices move out of line with prices of goods and services – inflation targeting becomes a myopic indicator that misses asset prices collapse (bubbles?), which threatens mass bankruptcy, recession and deflation.

So now a growing number of economists argue that central banks ought to target asset prices because of the huge damage subsequent collapses cause. This debate is an important element of the current monetary discussion, which also includes questions such as: How fast should the Fed normalized interest rate? Should the ECB expand its monetary impulse to avoid deflation? Is the BOJ battling a liquidity trap? Should monetary policy be targeted not at equilibrium in the real economy, but at equilibrium in the financial sector, as BIS recently postulated? etc.

These issues – jointly with the more general question about the effectiveness of monetary policy – are new waves of old discussions that go back to the great recession. As Bradford
DeLong recently reminded us\(^1\), they go back to 1936, when Keynes wrote: “It seems unlikely that the influence of [monetary] policy on the rate of interest will be sufficient by itself, … I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment.”\(^2\)

In his article, DeLong – who is an excellent saltwater economist – used this well-known Keynes’ quote because he wants to cast doubt on the effectiveness of Bernanke’s post-crisis monetary policy. “In the end,” DeLong writes, “Bernanke did not deliver. Even though the Fed and many other central banks printed much more money than economists would have thought necessary to offset the impact of the financial crisis, full prosperity has yet to be restored. … In his last years in office, Bernanke was reduced to begging in vain for Congress to institute fiscal expansion.”

Needless to say, Milton Friedman was very much aware of arguments favoring the use of fiscal policy over monetary policy, like the one DeLong makes in the previous quote. So he put forward an excellent metaphor – simple, albeit fundamental – to help us to avoid common mistakes when evaluating the effectiveness of monetary policy.

The metaphor became known as Friedman’s Thermostat. It states that in a house with a good thermostat we should observe a strong negative correlation between the amount of electricity consumed by the central heating system (monetary impulse, M) and the outside temperature (economic shocks, V).

But we should observe no correlation between the amount of electricity consumed by the heating system (M) and the inside temperature (nominal GDP or price level, P). And, moreover, we should observe no correlation between the outside temperature (V) and the inside temperature (P).

An unqualified spectator observing the data may conclude that the amount of electricity consumed (M) had no effect on the house temperature (V). Neither did the outside temperature (V). And he may conclude that the only unambiguous effect is that higher electricity consumption (M) seemed to reduce the outside temperature (V).

Another untrained observer, viewing the same data, may conclude that causality runs in the opposite direction. That is, that the only effect visible in the data is that an increase in outside temperature (V) reduced the amount of electricity consumed (M).

But both observers will agree that the amount of electricity consumed (M) and the outside temperature (V) are totally irrelevant and ineffective in changing the inside temperature (P). Therefore they may decide to switch off the house heating system, and stop wasting their money on electricity.

Besides being a neat metaphor, Friedman’s Thermostat helps us to clarify mistakes made even by well-known economists. For example those who argue that the Fed’s monetary policy during the crisis was ineffective because it frequently cut rates and “printed much more money than economists would have thought necessary… [and] full prosperity has yet to be restored.”

Although they may be acquainted with Friedman’s story, they do not even consider the possibility that Bernanke was turning up the monetary thermostat. However, the outside temperature fell so rapidly that the house was actually getting colder and the economy ended up with a “cool house policy stance.”

Likewise, Friedman’s Thermostat can shed light on the debate of monetary policy at the zero bound nominal interest rate. Saltwater economists would say that the economy is in a “liquidity trap.” That is, that the house is experiencing a power cut and, thus, the heating system is useless. An alternative explanation is that the heating system is too small to fight against the cold front that is sweeping across the region.

Friedman’s Thermostat is a metaphor that has very broad application. In fact, it has nothing in particular to do with monetarism or even macroeconomics. It was not even originally conceived by Milton Friedman. In reality, the metaphor is just a way of restating the importance of rational marginal thinking, a big idea that became a cornerstone of the economic

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\(^1\) The Tragedy of Ben Bernanke. Project Syndicate. October 29, 2015.

\(^2\) The General Theory - Volume 1 - Page 433.
Nearly two decades ago, when the concept of microfinance as a poverty reduction tool was still in its infancy, there was hope that providing microcredits would transform economic and social structures. With its focus on reaching the previously unbanked, microcredit was expected to bring about transformational change at the household level – a market in developing countries that traditional financial institutions had failed to reach.

Today, a growing body of empirical research on the effects of microcredit suggests that this belief may be outdated. In January 2015, the American Economic Journal: Applied Economics published a special issue devoted to impact evaluations of microcredit. The results of the six randomized controlled experiments executed across four continents pointed to increases in borrowing, self-employment activities and some business investments. There were also modest reductions in wage labor supply, while the impact on consumption was mixed. However, none of the studies showed transformational changes in terms of household incomes, wealth or poverty levels. Extending small amounts of credit to would-be entrepreneurs do have positive impacts, but not to the extent that some donors, policymakers and microfinance groups have claimed. The authors therefore conclude that microcredit serves as merely one of various key instruments in the fight against poverty.

Microfinance 3.0: Opportunities and Challenges

First, it was microcredit. Then microfinance. Now financial inclusion. Despite new names, the idea of providing financial services to the poor – in particular loans – has attracted a cult-like following.

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The notion that poor households need access to the full range of financial services to generate income, build assets, smooth consumption and manage risks is not a novel one. During the late 1990s, microfinance institutions (MFIs) began to construct a variety of innovative financial products and services around standard microcredit loans. Some MFIs added a strong savings component (compulsory or voluntary) or a training component (on livelihood asset management or financial education, for example); some began collecting repayments monthly and others weekly; and some preferred to lend to individuals (men or women) while others to groups of clients. Until today, the choice of lending strategies of MFIs has strong implications for their financial performance and for their social performance and achievement.

From microcredit to microfinance, the evolution of the types of financial products available to poor people across the world has been beneficial. In Bangladesh, for example, the rural poor have an almost “routine access” to microfinance services supplied by MFIs more than they have access to basic public services such as health, security, education, electricity, water, roads, information and so on (Rutherford, 2009). Not just in Asia, but globally, the microfinance sector has been flourishing over the past two decades. Estimates suggest that the $70 billion industry serves 200 million clients (World Bank, 2015) and will grow by 15-20 percent in 2015 (responsAbility, 2014). This is due to strong economic growth predictions for the 20 most important microfinance markets and the fact...
Despite the modest benefits associated with microcredit, critics cite a trend toward commercialization that is less focused on serving the poor.

An inherent consequence of a commercially-driven approach to microfinance has been that borrowers face exorbitant interest rates on their loans, often exceeding 100 percent. Another observed shortfall was over-indebtedness by some clients, who found themselves overwhelmed by multiple loans from multiple institutions (CGAP, 2012). All too often, customers simply borrowed more money to pay off their original loans. By increasingly focusing on financial performance, MFIs’ declared social mission of poverty reduction and empowerment seemed to have taken a significant back seat.

Another problem inherent in the traditional microfinance concept is that it widely neglects to serve the poorest of the poor: smallholder farmers with one acre of land, predominantly living in rural and remote areas. Of the three-quarters of the world’s poor that live in rural areas, 80 percent directly or indirectly depend on agriculture as their main source of income and employment (IFC, 2014). These smallholders also play a key role in increasing food supplies, more so than large farms in poor countries. Despite their socioeconomic importance, smallholders tend to have little or no access to formal credit, which limits their capacity to invest in the technologies and inputs they need to increase their yields and incomes and reduce hunger and poverty, both their own and that of others. MFIs interested in serving this market face myriad risks and challenges associated with agricultural production and lending, including seasonality and the associated irregular cash flows, higher transaction costs, and systemic risks, such as floods, droughts and plant diseases.

So, does microfinance work? Answering this question depends on the criteria used. When taken together with the industry’s for-profit incentive structure, the answer is “somewhat, but not that much.”

So, does microfinance work? Answering this question depends on the criteria used. If it is “can microfinance cover its costs and/or be profitable?”, then the answer is increasingly moving towards “yes.” But, if it is “does microfinance achieve its declared social mission (usually expressed as poverty reduction)?”, then the growing evidence on the modest effects of microcredit together with the industry’s for-profit incentive structure indicate the answer is “somewhat, but not that much.”

Today, microfinance fits within a broader framework of achieving full financial inclusion – a world where everyone has access and can use the financial services he or she needs to capture opportunities and reduce vulnerability (World Bank, 2013b). Compared to microfinance, the notion of financial inclusion takes on a more holistic view on fighting poverty, thereby including new products beyond the original enterprise credit. This encompasses all forms of credit, savings, insurance and payments; new populations, both upmarket and downmarket of the populations traditionally reached by microfinance, and new groups that microfinance has largely ignored, such as smallholder farmers; new platforms, using digital technologies to connect with people at more times and places; new providers – not just traditional microfinance institutions, but a range of private and not-for-profit providers, with governments supplying some helpful impetus through government-to-person (G2P) transfers; and new policies, facilitating the success of the above mentioned extensions. While microfinance covers a certain segment of the excluded market with targeted products, financial inclusion looks at everyone who is excluded and the full range of services they need.

References

A recent study has shed new light on how the ownership structure of competing firms by large institutional investors affects competition in the marketplace. A recent empirical economic study by Azar, Schmalz and Tecu (2015) focuses on a different channel affecting the degree of competition in a market: the ownership structure of competing firms by large institutional investors. In particular, they focus on the airline industry and show that horizontal ownership, where competing firms share the same group of large shareholders, results in 3-11 percent higher airline ticket prices compared to the case without horizontal ownership.

This article explains the rationale behind the anticompetitive effect of horizontal ownership and discusses some of its implications.

A Simple Example

To explain the underlying dynamics, imagine a town with, say, 10 restaurants. For the first scenario, suppose that the owner of one restaurant decides to buy up all others and to integrate them in one company. This newly formed company then has full pricing control in the market, and would increase its prices. Through higher prices wealth is transferred from restaurant customers to the restaurant owner, increasing the restaurant industry profit. At the same time, higher prices lead to a lower number of meals sold, which reduces the economic welfare.

Instead, imagine that the 10 restaurant owners get together one day and decide to collectively increase their prices. While remaining separate companies with separate ownership, they form a pricing cartel that imitates the behavior of a monopolist, inducing the same economic consequences as in the monopoly scenario above: higher industry profit, lower number of meals sold and lower economic welfare. There is, however, some fragility inherent in such a cartel agreement. Each restaurant owner has the incentive to slightly lower his prices relative to the agreed cartel price, as this would allow him to grow his market share and profit. The effect of such a unilateral deviation from the cartel price are lower profits for the competing restaurants and lower industry profit.

For the final scenario, suppose that an investor buys 51 percent of each of the 10 restaurants and that this change of ownership of all restaurants becomes commonly known among all restaurant managers. This new horizontal ownership structure affects each manager’s incentives. Both their compensation and job security depend on keeping the majority shareholder satisfied.

Morten Olsen and Giuliano J. Bandeen.
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A recent study has shed new light on how the ownership structure of competing firms by large institutional investors affects competition in the marketplace.

Horizontal ownership, where competing firms share the same group of large shareholders, results in higher prices as compared to that which does not have horizontal ownership, the study indicates.

Horizontal ownership structure affects the managers’ incentives since their compensation and job security depend on keeping the majority shareholder satisfied.
majority shareholder satisfied. Therefore, each manager’s best strategy is to maximize the restaurant portfolio value of the investor who holds a majority stake in each of the restaurants. The horizontal ownership structure makes its incentive compatible for each manager to act towards increasing the total industry profit. Therefore, as in the monopoly and cartel scenario, the prices of all restaurants will rise, increasing industry profit and reducing economic welfare.

The Drivers of Anti-Competitive Behavior

The example suggests that no monopolies or cartels are necessary for anti-competitive behavior, but horizontal ownership does the trick. In fact, in the case of horizontal ownership, no explicit communication among the different managers is necessary. Since they commonly know that increasing prices is in the interest of the common owner, it is in their own interest to do so as well.

Interestingly, the first two drivers of anti-competitive behavior are prevented by anti-trust regulation, while horizontal ownership is not regulated. This is particularly striking because the anti-competitive behavior is more robust under the horizontal ownership than in the cartel case. As argued above, in the cartel case there is always a temptation for each firm to unilaterally decrease its price in order to increase its own profits by taking market share from the other cartel firms. Instead, in the case of horizontal ownership, the temptation to do this is much weaker, as total industry profit decreases in response to a unilateral price decrease and therefore hurting the common owner.

The Rise of Institutional Investors and Horizontal Ownership

The proportion of total market capitalization of US publicly traded companies held by institutional investors increased from 7-8 percent in 1950 to 67 percent in 2010. No explicit communication among managers is necessary. Since they all know that increasing prices is in the interest of the common owner, it is in their own interest to do so as well.

No monopolies or cartels are necessary for anti-competitive behavior, but horizontal ownership does the trick.

Horizontal ownership has increased significantly in recent decades. The proportion of total market capitalization of US publicly traded companies held by institutional investors increased from 7-8 percent in 1950 to 67 percent in 2010.

The proportion of total market capitalization of US publicly traded companies held by institutional investors increased from 7-8 percent to 67 percent from 1950 until 2010. For 2015, some estimates put the institutional owned shares at up to 80 percent of total market capitalization. This aggregate data does not directly imply that horizontal ownership is a major occurrence but indicates that it might be so. A clearer picture is achieved when considering specific industries. For example, JP Morgan-Chase and Bank of America do not only operate in the same industry but also share the exact same group of institutional investors as their respective top four shareholders. The market leaders in the US pharmacy market, CVS and Walgreens, are to a large extent controlled by the same set of institutional investors. The top five shareholders of CVS are also the top five shareholders of Walgreens.

Economic Implications and Counter-Measures

We now know that horizontal ownership leads to anti-competitive, welfare reducing behavior, and that horizontal ownership plays a substantial role in the stock market. But inefficient situations often times offer opportunities. For example, the implicit collusion among horizontally owned firms might offer a profitable strategy for activist hedge funds. This strategy would be to take a large stake in only one of the horizontally owned firms and force management to lower its prices. As we have seen, such a strategy would indeed increase the firm’s profit. However, to be able to convince the management to lower prices, the activist hedge fund needs to own a larger stake in the firm than the institutional investors who also hold shares of the competing firms. Just recently, the hedge fund Trian lost a proxy fight at DuPont with the goal of achieving “best in class revenue growth,” which, translated, means taking market shares from DuPont’s competitors. Trian failed in inducing DuPont’s management to follow this alternative strategy, mainly because Vanguard, BlackRock and State Street opposed it. Unsurprisingly, these three institutional investors are the three largest shareholders of DuPont and three of the top four shareholders in Monsanto, which is DuPont’s main competitor.

A Preliminary Conclusion

What conclusions should be drawn? Azar, Schmalz and Tecu (2015) findings make a convincing case for regulators to have a close look at horizontal ownership by institutional investors.
investors. What could possible regulation look like? A very simple solution proposed by Posner and Weyl would be to disallow horizontal holdings within one industry. In other words, if an institutional investor takes a significant stake in Coca-Cola, it cannot at the same time hold a significant stake in Pepsi. When considering Posner and Weyl’s proposal in isolation, prices would decrease and economic welfare would increase.

However, it seems very hard to implement and would also rule out index funds, and generally make industry diversification via stock holdings impossible for large institutional investors. An alternative solution might be to force “passive” investors to remain fully passive in all but (at most) one company per industry. That is, not to allow any board representation and effectively putting up an “influence” firewall to isolate managers from the anti-competitive tendencies of their main shareholders.

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Manuel Mueller-Frank. Professor of Economics, IESE Business School

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6 Eric Posner and Glen Weyl, “Mutual Fund’s Dark Side”.
Selected Activities

**ALUMNI**

**Winners Dream with SAP CEO Bill McDermott**
Barcelona, November 17, 2015

Prof. Eric Weber

Bill McDermott is chief executive officer of SAP, the world’s business software market leader. He leads the company’s more than 75,600 employees and 2 million-person ecosystem in executing SAP’s vision to help the world run better and improve people’s lives.

Bill serves on the boards of directors for performance apparel maker Under Armour and engineering software maker ANSYS, Inc. He has received numerous awards for his civic leadership, including City Year’s Idealist of the Year, the We Are Family Foundation’s Visionary Award and the Children’s Aid Society’s Promise Award.

**Change, Internationalization and Japan**
Tokyo, November 26, 2015

Prof. Jan Oosterveld

This session will be led by Prof. Jan Oosterveld, who retired in 2004 as a member of the Group Management Committee of Royal Philips Electronics, where he was responsible for corporate strategy, corporate alliances, corporate restructuring, corporate venturing and the two joint ventures with LGE. As part of the latter role, he served as chairman of the Board of Directors of the LCD JV LG.Philips between LGE and Philips in Seoul. He led the IPO of LG.Philips in April 2004, the largest IPO in Asia that year.

Jan Oosterveld is a member of the Board of Directors of Barco in Belgium, Alent and Candover in the UK. and he is a senior advisor of Morgan Stanley. Jan has a management consultancy and investment company in the Netherlands and Spain. He is involved in five high tech start-ups.

**Corporate Family Responsibility: The Way for More Female Leadership and Sustainable Growth**
Tokyo, November 27, 2015

Prof. Nuria Chinchilla

Nuria Chinchilla is professor in the Managing People in Organizations Department and director of the International Center on Work and Family. As an economist and lawyer by training, she holds a Ph.D. in Management from IESE. Her areas of specialization include women and power, family-responsible organizations managerial competencies, career and time management, interpersonal conflict and not-for-profit organizations. In 1984, she became a full-time member of IESE’s faculty. Prof. Chinchilla is a business and government consultant and member of several advisory boards such as the VIP Advisory Board of European Professional Women’s Network (EPWN).

FOCUSED PROGRAMS

**Advanced Digital Media Strategies: Embracing the Digital Future**
New York, November 17-19, 2015

This course focuses on the "digital value chain." It will teach you where you and your business can extract the maximum value from a media product or service, from conception and design to production and rollout. This strategy process works for both new and legacy digital products and services by giving you the analytic tools and frameworks to develop winning digital strategies no matter what new or disruptive technology may come along. This is a crucial program for anyone interested in attracting more digital customers and building audiences for media and non-media brands.

**Doing Business Globally in a Matrix Organization**
New York, December 7-10, 2015

Many companies have turned to the Matrix organization as a model to deal with the challenge of running a global business. Such organizations typically have Senior Managers running specific geographies while others are responsible for global product units. Certain organizations even have fourth or fifth dimensions with Global Account Managers for customers or designated people overlooking concepts such as technologies or shared services. The problem, in many cases, is that these structures do not work as they were initially intended. Making the matrix work requires a combination of careful design from the organizational development point of view in addition to clear leadership behaviors of Senior Management.

**International Real Estate**
Barcelona, March 1-3, 2016

The bust of the housing bubble in the United States and some European countries has brought new scenarios to the real estate industry. Opportunities are moving from developed countries to growing economies such as Latin America, Africa and Asia. Learn how to manage real estate investments around the world as a developer, owner, service provider or global investor.

**Building and Leading High-Performance Teams**
Barcelona, March 15-17, 2016

Learning to lead a team is one of the most complex challenges a manager faces and therefore requires guided practice. Team members are often functional or divisional managers who provide partial views, have different behaviors, cultural backgrounds and very often conflicting interests, so understanding the levers and tools you can use to get the most out of your team is crucial. In this program, participants will learn how to create and lead teams that continuously excel, as well as how to carry out a complete team diagnostic and improvement plan.

The International Economic Overview is also available online, in Spanish as well as English. Access the publication at www.iese.edu/alumni/coyunturaeconomica