BRITAIN’S SUPERCOP
of Financial Services
Howard Davies, SLOAN ’80

Paul Romer on Economic Growth
John McMillan on Markets
MAY

MAY 3: Half-Century Club reunion, MBA classes of 1925 to 1951, Stanford campus. Contact Claudia Diven at 650.725.3767 or diven_claudia@gsb.stanford.edu

MAY 3–4: MBA class reunions for ’01, ’97, ’92, ’87. Stanford campus. Contact Lisa Brown at 650.724.4101 or brown_lisa@gsb.stanford.edu

MAY 4: 19th annual Black Business Students Association Conference, Stanford campus. Contact Nate Brown at 650.917.8740 or brown_nate@gsb.stanford.edu

MAY 5–10: Executive program “Finance and Accounting for the Non-Financial Executive,” Stanford campus

MAY 10: GSB Student show, Stanford campus. Contact Tad Glauthier at glauthier_tad@gsb.stanford.edu

MAY 19–24: Executive program “Leading Change and Organizational Renewal,” Harvard University

MAY 22–23: SEP 50th Anniversary Berlin Conference, Berlin, Germany. Contact Beverly Smith at 650.723.2921 or see www.gsb.stanford.edu/exed/sep50

JUNE

JUNE 13–16: GSB diploma ceremony, Stanford commencement

JUNE 20–23: MBA Class of 1977 25th reunion, Stanford campus. Contact Lisa Brown at 650.724.4101 or brown_lisa@gsb.stanford.edu

JUNE 23–JULY 5: Executive program “Marketing Management: A Strategic Perspective,” Stanford campus

JUNE 23–AUGUST 6: Stanford Executive Program, Stanford campus


JULY

JULY 7–19: Executive program “Financial Management,” Stanford campus

JULY 21–AUGUST 2: Executive Program for Growing Companies, Stanford campus

JULY 28–AUGUST 16: Stanford–National University of Singapore Executive Program in International Management,” in Singapore

AUGUST

AUGUST 4–9: New executive program “Mergers and Acquisitions,” Stanford campus

AUGUST 4–16: Executive Program in Strategy and Organization,” Stanford campus

AUGUST 12–16: Executive Program in Leadership: The Effective Use of Power,” Stanford campus


FUTURE EVENTS


SEPTEMBER 15–20: Executive program “Advanced Management College,” Stanford Sierra Conference Center

SEPTEMBER 26: First day of regular MBA classes, Stanford Business School

OCTOBER 6–11: Executive program “Electronic Business and Commerce,” Stanford campus

OCTOBER 13–18: Executive program “Credit Risk Modeling for Financial Institutions,” Stanford campus

OCTOBER 18–19: Fall Alumni Weekend and MBA class reunions for ’52, ’57, ’62, ’67, ’72, ’82, Stanford campus. Contact Claudia Diven at 650.725.3767 or diven_claudia@gsb.stanford.edu

NOVEMBER 1: Alumni conference in Hong Kong. Contact Laura Moore at 650.723.2694 or moore_laura@gsb.stanford.edu

See the alumni online calendar at www.gsb.stanford.edu/alumni/events/calendar.html

For details on Executive Education programs, see the advertisement on page 25 or visit www.gsb.stanford.edu/exed
FEATURES

16
The Regulator
Executive chairman of Britain’s Financial Services Authority, Howard Davies, Sloan ’80, eschews the traditional formality of his country but feels right at home as the most powerful financial services regulator in the world.

BY JOHN O’RYAN

20
A Natural History of Markets
In his new book, economics professor John McMillan explores markets ranging from ancient bazaars to eBay and explains what makes or breaks a marketplace.

BY JOHN MCMILLAN

DEPARTMENTS

About This Issue | 2
Dean’s Column | 3
Spreadsheet | 4
What’s Up: News about the GSB and its graduates.

Public Management | 8
How do you talk risk-averse bankers into investing in low-income neighborhoods?

BY BILL YOUSTRA, MBA ’92

People | 10
Richard Scurry, MBA ’65
Kristin Majeska, MBA ’94

Yesterday | 11
Hug Club students in 1985 wanted to make the Business School a friendlier, more cuddly place to get an MBA.

Opinion | 12
If America is to maintain its growth rate, the government needs to invest in future scientists and engineers.

BY PAUL ROMER

Southeast Asia | 14
Stories from Bangkok (Jonathan Hayssen, MBA ’81) and Hong Kong (Regina Ip, Sloan ’87) illustrate the diversity of GSB alumni.

Faculty News | 26
Faculty Publications | 27
Faculty Research | 28
Measuring the performance of top-level executives > Free trade should not be blamed for worker upheaval > People adapt to predicted outcomes > The timing of venture capital funding matters

Newsmakers | 32
Who’s in the news: A roundup of media mentions.

Class Notes | 35
about this issue

Anchoring Your Globetrotting

This magazine might appear to some as having “globalized” since the last issue. We have followed alums, faculty, and students to a variety of locales including Bangkok, Hong Kong, London, and East San Jose. We also report on the “Winning Globally” conference that researchers from the School’s GLOBE Initiative and from McKinsey hosted in January. If you attended the conference, you heard that devising a product that will satisfy customers around the world is a huge challenge. That is no less true for a magazine than for an automobile or a wine, but at least Stanford Business has the advantage of knowing that the bulk of its readers have been exposed to the Business School’s culture and hopefully return physically for a new exposure now and then.

Since we are located on the Stanford campus, we naturally hear more about those of you who live and work in the Silicon Valley. While we must guard against becoming a Silicon Valley-only magazine, some alums who live elsewhere have said they read this magazine precisely because it keeps them posted on and attached to an interesting and innovative group of people whose network hub is the gsb and San Francisco Bay Area.

But business these days requires a global perch as well as a local one, and it is that global perch that the GLOBE Initiative folks are trying to better define through research on global companies with wide-ranging styles of operation and products. What percentage of alumni/ae would say they work with a global concern? The definitions of global companies need to be firmed up before we can answer this question definitively, but I am certain the number grows nearly every quarter. The researchers would love to hear about your global challenges (email benjamin_beth@gsb.stanford.edu) and so would the magazine editors (email otoole_kathy@gsb.stanford.edu). Whether you’re just down El Camino or half a world away, you are part of an innovative GSB network.

A member of that network, Robert L. Strauss, MBA/MA ’84, interviewed Jonathan Hayssen, MBA ’81, in Bangkok last year while on the way home from working on a CARE project in Sri Lanka; he subsequently wrote the story on page 14 for Stanford Business. Strauss has known Hayssen since going to Thailand in 1984 on a development assignment. Now, 22 years after serving as a Peace Corps volunteer in Liberia, Strauss is returning to the Corps as country director in Cameroon, where he will manage 135 volunteers working in education, health, agro-forestry, and small business.

Closer to home, Bill Youstra, MBA ’92 and a former AOL VP, has been following the innovative community development efforts of his classmate Eric Weaver in Silicon Valley. Youstra was moved to submit the story on page 8 after observing how Weaver’s work has helped attack the social hardships brought on by dot-com inflation in the late nineties.

Our May cover photograph of Howard Davies, Sloan ’80, was taken by one of Britain’s foremost portrait photographers, Jillian Edelstein. With a string of prestigious awards attached to her name, Edelstein used her considerable skill to give us a strong image of Britain’s financial regulatory services’ top gun.
A Commitment to Lead

The managed institution is society’s chosen instrument for the best way to produce and deliver its goods and services, both public and private. Management—as embodied in effective, ethical, disciplined, high-achieving teams of managers—is responsible for how well these institutions perform. Worldwide, the difference between outstanding and poor institutional performance can be measured in hundreds of millions of jobs and trillions of dollars of income and wealth gained or lost. It is the responsibility of the managers within those institutions to deliver their performance.

Much management skill is learned and developed through on-the-job experience. But there is an important body of knowledge that serves as an essential and lifelong foundation for anyone seeking a satisfying professional career involving management.

Creating and disseminating that body of knowledge is a critical part of the mission of the Stanford Graduate School of Business, where we aim to lead the world in the promotion of learning about management—about what it is, what it does, how it can become better; how to recognize it, develop it, hold it accountable.

The vast majority of our alumni recognize this, but occasionally we hear from some of you who believe management education might have taken a wrong turn. In recent months, I’ve heard from several of you who are embarrassed by the bad publicity that professional management is getting in the wake of the collapse of the Enron Corp. Some of you are disturbed that a valued teacher, a former dean of the school, has been criticized publicly for his role on the company’s board of directors, and you want to know what the School’s leadership is planning to do about it.

Obviously, something went very wrong at Enron and needs to be thoroughly investigated and reviewed. This is happening now—through the courts, the media, and the Congress. I have no doubt that this investigation will be thorough and instructive. As Dean of our School, I am not going to prejudge anyone on the basis of media speculation and certainly am not going to prejudge Bob Jaedicke—a person I have known for nearly 37 years to be of the highest character and competence. Bob will undoubtedly be in the public spotlight for some time and will be explaining his role on the audit committee and the board. For me, his professional career and record have earned him the right to our patience and consideration before making judgments. I have read with interest a transcript of his recent testimony before Congress—I suggest it to anyone interested in this matter—and I hope the GSBS community will join me in, at least, suspending judgment until the whole story has been told.

That said, I share concerns about the far-reaching management issues that the Enron story has exposed and am determined to redouble our course and teaching efforts in such areas as leadership, values, ethics, and decision making. Stanford Business School is one of those exceptional institutions that makes a critical difference through our impact and leadership. We have a required pre-term course in ethics, and issues addressing ethics are then found in many courses throughout the curriculum. We also offer a number of courses under the subheading of “leadership” in the elective choices. One of our accounting professors is already planning a session to deconstruct some of Enron’s practices.

I assure you that issues of integrity, values, and ethics in decision making are at the forefront of what we do here. My own seminar, “Issues in Leadership,” dwelled heavily on issues of integrity and values throughout the readings and discussions, as I am confident the students would report to you. We have accelerated faculty and fundraising efforts to expand our recently developed Center for Social Innovation, which is developing teaching and research around issues of nonprofit management as well as ethics.

I am committed along with our faculty to raising the awareness and importance of social responsibility and ethics throughout the curriculum and the experiences that students have while they are here at Stanford.
Civilized Table Conversation is not necessarily a skill developed by the fast-food generation. Yet in this gulp-and-go world, GSB students have made good food and—more important—leisurely dinner table exchange part of their student life.

Hungry for dinner fellowship, some 260 MBA students signed up this year for the e@t club. At one club event in early March, second-year Victoria Dimitrakopoulos (pouring wine in photo above) cooked up a meal for club participants including Bart Menayas (left) and Hubert Sonnelet (right) and his wife, Brigitte.

At ordinary standup social events, the guests chat with each other for a few minutes and then move on, never getting beyond the top layer of pleasantries. So, 15 to 20 times each quarter, e@t members pull up chairs and spend two or more hours sharing food, drink, and the kind of conversation that can build real friendships. “You can make great friends when you find yourself in any situation where you spend some period of time together talking,” says Menayas, one of the club’s copresidents.

Most dinners involve 10 to 12 guests selected through a system that mimics the Business School’s bidding system for its elective courses. Instead of wagering the silver bullets students use to get into popular classes, e@t members bid chocolates for the chance to sup on sushi, Indian cuisine, or some other meal whipped up by a classmate.

“Many Americans find cooking scary,” jokes French citizen Menayas. Yet e@t members rise to the occasion. The club has extended its membership to a few recent alums, including Daniel Beltramo, MBA ’94, who hosted a dinner featuring wild boar (the result of a hunting trip) and chutney made from Beltramo’s homegrown peaches.

“It’s not all that much harder to cook for 20 than for 4,” says Menayas. Last year the club hosted a Friday night LPF to attract new members. “I think we had food for more than 600 people. We got a little carried away, but it was a great evening,” he recalls.
Winter Readings
Break the Ice

A JUNKIE FOR BOOKS on business topics, second-year student Jeral Poskey suggested coordinating book reading over the December 2000 holiday break with a discussion to follow in January. Student life director Courtney Payne took up the challenge and “Books on Break” became an immediate success. Repeated this past winter, students, faculty, and alumni/ae filled up new book-reading groups within minutes of their posting on the gsb Web site.

“It’s always interesting to see what other topics [the professors] like and to know they are multidimensional,” first-year student Adrienne Klembara told the Reporter. She read Snow Country, a book about a Japanese geisha, which was chosen by professor emeritus Jim March. March provided sushi for two group discussions.

In general, readers enjoyed a break from business books, with novels being especially popular. First-year student Carl Palmer did not like reading The Natural, but said that it generated a great group conversation. The discussions were “more intimate than what you normally see in a large class,” said associate professor Deborah Gruenfeld, who hosted two discussions of the book Our Separate Ways.

The overarching lesson from the experience, according to first-year Shani Jackson, should be that “a simple idea, carried forth, can make a huge impact on the culture of the School.”

Gardner Awards

IN MARCH, the Stanford Business School Alumni Association for the first time presented two John Scully Wins Arbuckle Award

Thirty-eight members of the MBA Class of 1968 joined nearly 400 other guests at a February dinner to honor John Scully as the School’s 32nd Arbuckle Award winner. Scully founded SPO Partners, a private investment firm and merchant bank, two years after earning his MBA degree.

Before turning to a more serious note, Scully and his classmates traded good-natured jibes about Scully’s undergraduate success selling a product known as Mojo Love Oil.

“1966 to 1968 was an extraordinary juxtaposition of a very prosperous economy with a period of political unrest, combined with a gathering at the GSB of highly motivated young men. (It was 98 percent men, and half the class was right out of undergraduate.) We were brought together to a school literally blossoming under the leadership of Ernie Arbuckle,” Scully recalled.

Attending the dinner were 13 recipients of MBA fellowships established by Scully in honor of his parents. Scully is also chairman and founder of the Making Waves program that provides tutoring, mentoring, and college guidance to more than 350 inner-city youth.

John Gardner, Social Reformer, Dies at 89

John W. Gardner, who played a central role in the creation of Medicare and coined the term “independent sector” to capture the idea of the latent potential within America’s nonprofit institutions, died February 16 at age 89 in his Stanford campus home. A consulting professor in the School of Education at the time of his death, Gardner joined the GSB faculty in 1989 as lecturer in organizational renewal and leadership and held a University chair in public service. The School chose him to receive the 23rd Ernest C. Arbuckle Award in 1993. Former GSB Dean Arbuckle and Gardner met as Stanford undergraduates, and Arbuckle called upon Gardner for advice when he first became dean.

Gardner was secretary of health, education, and welfare in the Johnson administration, when Medicare was created. He founded Common Cause, a citizens’ advocacy group that aims to make political institutions more open and accountable. He also cofounded Independent Sector, which supports hundreds of nonprofit groups nationwide.

Dean Robert Joss recalled meeting Gardner in the late 1960s when Joss was a White House Fellow. (Gardner helped establish the program.) More than three decades later, noted Joss, Gardner inspired him to become the School’s eighth dean. “He had a tremendous concept of leadership and what it meant to be a citizen,” Joss said.

Step in Business but said that it awards named after the late John Gardner to recognize the contributions of outstanding volunteers. Jerry Tomanek, MBA ’73, and Noel Fenton, MBA ’63, were honored with the John W. Gardner Volunteer Leadership Award recognizing 25 years or more of service to the School. Lynn Utter, MBA ’86, and Susan Austin, MBA ’93, received the John W. Gardner Volunteer Service Awards.

Resources for Global Managers

Companies in globalizing industries often pay “too much attention to acquiring assets and too little to how they are going to improve their ability to access and serve customers,” said Lorenzo Zambrano, MBA ’68, at a conference on “Winning Globally,” held at the GSB winter quarter. Zambrano is chairman and CEO of CEMEX, one of the world’s largest cement companies.

Sponsored by the Stanford/ McKinsey GLOBE Initiative and the GSB’s Global Management Program, the daylong event provided a chance for executives from different leading global businesses to compare notes on the challenges they face.

In his keynote address, Zambrano cited Stanford ties as an important element in CEMEX’s success. Several other prominent speakers focused on the challenges of managing brands, addressing ethical issues, and sustaining growth in tomorrow’s global economy.

The conference also showcased initial findings of the GLOBE Initiative, a research-based study of global firms. Working with a growing number of companies, GLOBE is studying the mechanisms used by large firms to address the tensions that arise when they attempt to “think global, act local.” Researchers identified seven levers, or “drivers,” that companies use in combination to resolve global–local tensions and evaluated which combinations work best in different global contexts.

To view GLOBE’s initial findings or to learn how you can help further GSB research while gaining insights about your own company’s ability to “think global, act local,” visit GLOBE’s Web site at www.gsbo.stanford.edu/globe or call 650.724.4508.
New on the Bookshelf

The Business of Options: Time-Tested Principles and Practices
Martin P. O’Connell, JD/MBA ’70
John Wiley & Sons, 2001
A guide to using options as a tool for investment and managing risk.

Defining Markets, Defining Moments
Geoff Meredith, MBA ’70, and Charles Schewe
Hungry Minds Inc., 2001
A marketing approach that looks at customers as multidimensional beings and focuses on the concept of generational cohorts as the most influential of five factors that shape marketplace behavior.

Good to Great: Why Some Companies Make the Leap ... and Others Don’t
James C. Collins, MBA ’83
HarperBusiness, 2001
Collins’ attempt to uncover how average companies can morph into greatness through good old-fashioned discipline. Listed on numerous best-book compilations.

Jews in American Politics
Louis Sandy Maisel and Ira Forman, MBA ’83 (eds.)
Rowman and Littlefield, 2001

Internet Commerce Metrics and Models in the New Era of Accountability
Sri Jagannathan, Sloan ’96; Jay Sririnvasan; and Jerry Kalman
Prentice Hall, 2001
A framework for e-business investors and managers that includes business models for content development, community/markets, pricing, customer acquisition, and infrastructure.

Results from the Heart: How to Instill Commitment in Your Employees by Helping Them to Fully Develop Their Talents
Kiyoshi Suzaki, MBA ’81
The Free Press, 2001
How creating “mini-companies” within larger organizations can have a positive effect on employees’ sense of purpose. Foreword by the Dalai Lama.

Building Capacity Within Nonprofits
“I was panicked the first week at the pace, but as the course went along, the things we talked about fit into a full picture,” said Thomas Haar, director of Family Services Agency Inc. and one of 49 leaders of nonprofit organizations who participated last summer in the School’s first Executive Program for Nonprofit Leaders (EPNL). They came from health care, education, and community development organizations.

A similar group of participants was scheduled for this March, and a third session, planned for June, will be held for executives of arts organizations. It is a joint project of the School’s Center for Social Innovation and National Arts Stabilization, an arts group interested in developing the art world’s managerial and financial skills.

The programs offer much of the same educational framework the School long has provided to for-profit leaders in its executive education programs. The program’s purpose, according to EPNL director and faculty member James Phills, is to provide the growing nonprofit sector with the skills to be effective stewards of the billions of dollars contributed to their organizations every year.

Participants in the first program said they took away new ideas on how to refine their missions, improve their use of human resources, and evaluate their effectiveness; they also made mentoring friendships. Sheryl Brissett-Chapman of the National Center for Children and Families said she was surprised to find how similar her work was to profit-sector entrepreneurship. Added Edward Kelley of RFK Children’s Action Corps Inc.: “Nothing has moved my thoughts about how I manage my agency more than these two weeks.”

Green Opportunities for Entrepreneurs
FOR TERRY ANDERSON, NO VACATION MEANS ENCOUNTERING THE WILDLIFE OF BOTSWANA’S OKAVANGO Delta from the top of a horse. If you prefer an elephant, they are available too but at more than double the price, or $2,000 a day. Licensed by governments, operators of ecotourism services can earn large profits and preserve natural habitat, Anderson tells students, but one problem with investing in them is that governments can, and often do, change the terms of the contract.

Ecotourism is just one of many cases of “environmental entrepreneurship” that Anderson discusses in a new GSBS course by that name. Along with a course in environmental regulation taught by Robert Grady, MBA ’88, it is made possible by a donation for environmental sustainability initiatives from Heidi, MBA ’90, and David Welch of Menlo Park.

Anderson’s course is designed to get students to think of the environment as something more than regulations to cope with or as “the thing that’s left over after...
making money,” says Anderson, a senior fellow at the Hoover Institution and executive director of PERC—The Center for Free Market Environmentalism in Montana. “We talk about turning the environment from a liability, which is what regulations make it, into an asset. We deal with everything from paying ranchers for damages caused by Yellowstone’s wild wolves out of wolf poster money, to ideas for converting waste streams, such as steel slag or waste water, into ingredients in other products,” Anderson says.

**Room for Relaxation**

**Room 100 of the GSB South building** was converted in February to a sleek student lounge, outfitted with leather seating and two large TV screens, thanks to the Class of 2001. While students have many places to relax at the Schwab Residential Center, indoor space for informal meetings with friends has been in short supply in the academic building complex. But the environment is on the upswing, with the Class of 2000 renovation of the second floor of Jackson Library and the improvement of the South building’s terrace funded by the Class of 1999.

**Shultz and Perry on National Security**

**Two Stanford sages of national security**—former Secretary of Defense William Perry and former Secretary of State George Shultz—shared views of the world’s current dangers with GSB audiences during winter quarter. Perry, a Democrat, predicted a U.S. showdown with Iraq, and Shultz, a Republican, counseled against expecting any resolution of the India–Pakistan dispute over Kashmir in the near future. Shultz is the GSB’s Jack Steele Parker Professor of International Economics Emeritus. Perry, a Stanford engineering professor, is an SEP ’74 alum.

Shultz, who negotiated with the Russians over their Afghanist withdrawal and on missile deployment, offered “10 commandments of negotiation.” He cautioned against forcing an agreement on negotiators when their constituents don’t support it. U.S. leaders should work to reduce the tension between India and Pakistan, Shultz said. “They need to contain it, to stop aggressive actions, but the situation needs to evolve” before useful mediation can begin.

Perry, who helped revise post-Cold War U.S. military strategy, said investment in information technology has paid off in the Gulf War, the Balkans, and in Afghanistan, but U.S. battlefield superiority also has prompted enemies to try “asymmetric warfare,” such as the 9-11 attacks. The terrorist threat requires added effort by public health and law enforcement agencies, he said, with special attention to weapons of mass destruction. He predicted military action against Iraq in 2002 if that nation does not allow UN weapons inspections again.

**Today**

You could have heard a pin drop in any classroom of the GSB last December 16, when this photograph was taken high above the Stanford campus.

Assigned to armed combat air patrol “Operation Noble Eagle,” 144 Fighter Wing California Air National Guard pilot Capt. Kirk “Hawk” Hawkins spent his Sunday piloting his F-16 fighter jet as he kept watch over the San Francisco Bay Area skies.

Hawkins, a ’94 Stanford MS engineering graduate, is a fellow fighter pilot of Business School alumnus David Fleshman, Sloan ’01, who was called upon in the days immediately after September 11 to help keep the skies over California safe.

**Photo by Lt. Col. Jon Tagget**
Real Business, Real Results

Eric Weaver, MBA ’92, treated an East San Jose neighborhood like an emerging market and successfully persuaded traditional banks to invest in the community.

That was the idea, but the sources of money and of needed insight are not necessarily the same. This is the story of how one GSB graduate, drawing on a broader, sustained infrastructure supporting venture philanthropy, built a successful nonprofit dedicated to improving the quality of life for thousands in Silicon Valley. In doing so, he consistently relied on the resources and expertise of other successful managers—from both the nonprofit and for-profit sectors—often facilitated by other GSB alums.

In 1992, a group of Silicon Valley bankers met with Peter Hero, MBA ’66, of Community Foundation Silicon Valley (CFSV) to discuss the challenge of a new federal law, the Community Reinvestment Act, which required banks to invest in low-income communities. While the banks supported the spirit of the law, they struggled with how to put bank dollars to work with maximum community development impact while maintaining alignment with the banks’ business practices and low appetite for risk.

In typical Silicon Valley thinking, the group decided that a startup would be their best course. They hired Eric Weaver, MBA ’92, who had just graduated from the GSB and had experience working in low-income communities. The original steering committee included then-Bank of Santa Clara president Bill Scilacci, MBA ’49, who would mentor Weaver. Hero offered a cubicle, office support, and the good name of CFSV. Silicon Valley Bank offered to pay Weaver’s salary while he wrote a business plan for investment in affordable housing and small business.

More than two years of planning, financial modeling, and market analysis went into the original plan. “I wanted to look at underserved neighborhoods like East San Jose as emerging markets and figure out what sort of demand they represented,” Weaver explains. “There was a credit gap. Dollars were flowing out of these communities. They showed classic signs of decay: deteriorating commercial strips, vacant lots, and abandoned buildings. Clearly, there was the opportunity to bring in some outside capital. The trick was to make it worthwhile as an investment for local banks.”

Weaver proposed a financial intermediary called Lenders for Community Development (LCD), incorporated in 1993 by 15 member banks. While the banks never intended to earn a profit...
from LCD, they hoped to receive regulatory credit from the federal government for participation. This credit would afford them the flexibility to open or close branches and to merge with other financial institutions. The banks had one other requirement: LCD was to preserve the banks’ principal. They were willing to sacrifice some rate of return in exchange for community development impact but did not want to create a pattern of grant making disguised as loans that would inevitably be written off.

Weaver counted on this businesslike philosophy to build confidence in LCD. Though his “product” was a community benefit and regulatory flexibility, he nonetheless competed for the banks’ investment capital, which could be invested elsewhere for a higher return. “We ended up applying basic financial principles to meet our investors’ requirements: sharing risk through pooled funds, creating backstops for losses, and finding philanthropic subsidies to fund operations,” Weaver explains. “Beyond these mechanisms, we’ve attracted investors who are interested in social as well as financial return. We offer them specific, measurable goals—for example, number of units of housing built, number of loans made, number of low-income entrepreneurs funded, number of jobs created and retained—and we monitor and report on our results.”

Since its first loan in January 1995, LCD has originated more than $17 million in affordable housing and community facilities loans, financing 1,700 units of housing and five new facilities.

How has it worked? East San Jose is host to a working-class, predominantly Latino neighborhood called Mayfair. Plagued by poverty and unemployment, Mayfair has long been a community revitalization project for both the city and CFSV. In 1996, LCD financed a 34-unit town home project that ultimately extended home ownership to families earning 65 percent of area median income and less. Four years later, thanks to LCD, the Mexican American Community Services Agency acquired a commercial building for its youth outreach programs.

Most opportunities require “predevelopment” loans. These provide nonprofit developers with the seed capital they need to perform the necessary feasibility studies and tie up available parcels of land. Typical banks are unwilling to provide this early financing because of the uncertainty of the development outcome. Despite this risk, LCD has not experienced a single loan loss on its housing lending activities.

Through its Small Business Program, LCD has provided $2.4 million to more than 100 entrepreneurs, with 75 percent of loans going to minority-owned businesses, 52 percent to women-owned businesses, and 87 percent to businesses owned by low-income people. The demographic profile of LCD’s borrowers is clearly different from the borrowers reached by a typical commercial bank. LCD does not offer below-market interest rates but may bend on other key factors that determine loan profitability, such as loan size, transaction costs, or repayment risk. Its focus on community lending allows LCD to offer loans as small as $1,000 and to work diligently and creatively with the borrower to make a deal work. It also allows LCD to lend to those with limited track records and no collateral.

Robin Hunt is an example. Operating a growing hair-braiding business in East San Jose, Hunt sought financing to expand. The banks turned her down, citing a lack of collateral and insufficient borrowing history. After thorough due diligence, LCD lent Hunt $15,000. Two years later, she has opened a second location, and business is booming.

LCD has borne losses of approximately 3 percent on its small-business lending. This is slightly above what commercial banks experience but substantially below the 10 to 15 percent that similar community investment programs typically experience.

There are two possible reasons for the low loss rate: LCD does an excellent job managing their loans, or they’re selective. But there is a danger in the latter. Because LCD’s charter is to accept risks where commercial banks would be less comfortable, one should notice a difference in loss percentage. LCD claims the difference is small because of sound underwriting and long-term follow-up with borrowers.

On even modest loans, due diligence is performed not only on behalf of LCD but for the prospective borrowers. “It’s never in a borrower’s long-term interest to undertake a loan they will be unable to repay,” Weaver says. “We owe it to ourselves, our member banks, the community, and our borrowers to make sure everyone is in a manageable position.” This painstaking process is buttressed with creative use of government and foundation funds to provide guarantees and reserves as a backstop against loan losses.

LCD’s third program area is truly on the cutting edge of community development in America. Borrowing a concept from 401(k) retirement programs, LCD and partners match a family’s savings. Participants take a five-week money management course and then begin saving an average of $50 per month over a two- to three-year period. Every dollar that a family adds to its savings is matched two-to-one. At the end of the period, the savers can use their own funds plus the match money for one of four investments: home purchase, buying or investing in a small business, paying for education, or opening a retirement account.

More than 500 participants are enrolled in this program, which is operated by LCD in partnership with the Center for Venture Philanthropy, Citibank, and several other area nonprofits. Despite the typical savings obstacles for low-income families (the average saver’s income is $25,000—desperately low for Silicon Valley), the participants have saved a collective $750,000 in less than three years. Eleven have become homeowners. Robin Hunt—the borrower with the hair-braiding business—used some of her savings to buy inventory and equipment for her new business location.

Once merely a beneficiary of CFSV’s infrastructure, LCD, with a staff of 15, is now a supplier as well. Weaver has become an expert that Hero taps for philanthropists and new nonprofit ventures. Weaver’s experience and GSB education provide a solid foundation for both the nuts-and-bolts demands of LCD as a financial institution and the requirements to fulfill its social mission.

“The dramatic growth of our programs has forced me to deal with the same challenges any successful entrepreneur in the private sector would face,” Weaver says. “Attracting, developing, and retaining the right people to make these programs work is a top priority. This work is highly satisfying, as it offers all of the challenges of any fast-paced, high-growth business environment. Those who join us want more. We offer the chance to make a difference.”

The Silicon Valley nonprofit scene is well populated with alums like Weaver, who deliver on the sustained promise of venture philanthropy rather than the short-lived worship of Internet riches. The promise is being delivered day by day, as talented executives manage growing businesses that feed into this local network.
Richard Scurry, MBA '63

When he returned from a 1994 trip to Russia, Richard Scurry was excited. With tens of thousands of other American Christians who had been invited by Gorbachev’s education department to teach the Bible to Russian school-teachers, he had learned firsthand what happens to a child’s education when a core piece of Western history is missing. “People were telling us that the worst mistake they had made in 70 years of Communism was taking the Bible out of schools,” Scurry says.

Today, Scurry, MBA ’63, is a partner working half time at the Jefferson Financial Group in Manhattan and also vice president for development of the Bible Literacy Project, a nonpartisan, nonprofit organization of business people dedicated to the academic and objective study of the Bible and its influence on Western civilization. The Project, in conjunction with the Freedom Forum, has developed “The Bible and Public Schools, A First Amendment Guide,” endorsed by 18 organizations, including Jewish, Christian, and Muslim groups as well as the two national teachers’ unions. It is the first consensus statement on teaching about the Bible in 160 years of U.S. public schools.

Scurry reports that many teachers, including atheists, are enthusiastic about this project because the Bible is foundational to Western culture. Large portions of history, literature, art, and especially English are based on scriptural references and cannot be fully understood without that key resource.

The Project has met with educators in 22 states so far, but Scurry notes real change will happen at the local school board level. The Project currently is putting together a pilot curriculum for schools in Dallas.

On his personal beliefs, Scurry says with humor: “I always went to church, but family and business were my priorities, with religion way down the line somewhere behind football.” After a series of experiences following the death of his best friend, George Clark, MBA ’63, he now describes his faith as life changing. Asked about his commitment to the Project, Scurry replies, “I’m 63 years old. At some point you have to start giving back.” —Lisa Eunson

Kristin Majeska, MBA ’94

Shopping at a public market in Portland, Maine, one day in 1999, Kristin Majeska inquired about the expensive organic beef she spotted. Erick Jensen, manager of a farm that had been willed to a nonprofit organization, explained that his processing costs were three times those of feed lots because of the small volume.

“We started talking about ways to increase the volume and partnering with farmers in northern Maine rather than having his coastal farm add more cattle,” recalls Majeska, MBA ’94. Together they developed a business plan, and Jensen tapped into the newly created Common Good Ventures, a venture philanthropy arm founded by Majeska with support from the Maine Community Foundation. Jensen’s Wolfe’s Neck Farm now partners with farmers in the economically depressed northern part of Maine who also raise cattle without use of hormones, antibiotics, or animal by-products in their feed. The meat is sold to Boston-area supermarket chains that promote the brand’s natural qualities. Consumer demand for the premium product has led to higher income for the farmers.

Majeska’s Common Good, meanwhile, is making grants and providing business advice to other nonprofits that want to further their social goals and increase their financial self-sufficiency through mission-related businesses. Some of these partners are training and job-creation organizations; one is a catering service whose primary mission is providing nutritious meals to low-income children in day care.

“For us to invest, an organization has to have a believable business plan that shows how they will break even in approximately three years, including extra costs associated with using the business to accomplish their social mission,” says Majeska, who contributed a chapter on marketing to Enterprising Nonprofits (John Wiley & Sons, 2001), which was coedited by former GSB professor Greg Dees. Her current work “draws heavily” on her previous private-sector consulting and her Stanford Public Management Program experience and connections, she says. Another advantage of her MBA, Majeska says, is “the confidence to do something interesting and meaningful wherever you go. I’m in Waterville, a town of 17,000 people 75 miles north of Portland, and I still found great work to do.” —Kathleen O’Toole
IT WASN’T quite the Summer of Love, but 17 years ago there was a lot of huggin’ goin’ on at the GSB. Founded by then second-year student Mike McTeigue, with help from his classmates Todd Harris, Mickey Levitan, and Susan Toeniskoetter, the Hug Club filled a market niche for some 125 GSB students who were looking for a way to mitigate some of the stress of school. Armed with the motto “Dare to Hug,” prospective club members achieved charter status by completing the required coursework—certified hugs for 20 people. Easy for some, “extra credit” for others.
Growth Hinges on Science Education

Paul Romer argues that too few college students receive undergraduate degrees in science and engineering, and the shortage is one factor affecting economic growth.

WHY THE TREND RATE OF GROWTH MATTERS
In 1870, Britain was the world’s most productive economy. Output per person in the United States lagged far behind. Since then, the rate of growth in the United States has been higher by about 0.5 percent per year. This difference may sound small, but after 130 years, it has a huge cumulative effect. By the beginning of the 20th century, annual output per head in the United States had pulled even with Britain. By the end of the century, it was higher here by $10,000 (in the purchasing power of 1996 U.S. dollars).

By way of comparison, during the recession of the early 1990s, output per head in the United States fell by about $500 in 1991 and returned to its previous level in 1992. This kind of temporary reduction in output is dwarfed by the permanent $10,000 difference created by a faster trend rate of growth.

SOURCES OF GROWTH
Economists cannot say with certainty why growth in the United States has been faster. Given the state of our knowledge, we can only point to a list of candidate factors and steer people away from the most basic pitfalls in thinking about growth.

Three broad factors contribute to growth in output per capita: 1) increases in physical capital—the buildings, machinery, and infrastructure that we use in daily life; 2) increases in human capital—the skills and experience of the workforce; and 3) increases in productivity—a catchall category that includes the many large and small discoveries that lead to the introduction of new goods and services or to more efficient production of existing goods and services.

A myriad of national institutions and government policies determines the rate of increase along these three dimensions. For example, legal and financial systems channel capital goods to promising firms. Formal educational opportunities and on-the-job training increase skills and experience. Research and development and the pressure created by intense competition spur the discoveries that raise productivity. Excessive rates of taxation or burdensome regulations can slow progress along all three dimensions.

The most common mistake in thinking about growth is to search for the “silver bullet,” a single policy that is everywhere and always the key to faster growth. In fact, it is a whole range of policies and institutions that must work together to sustain a high rate of growth. Each is more valuable when it is adopted in conjunction with all the others.
In setting national policy, a better strategy is to find the “weakest link,” where current policy is far from ideal and it would be easy to do better. At different times and in different countries, this weak link may vary.

LAGGING BEHIND OTHER COUNTRIES

There is one clear area in which the United States now lags behind and could make rapid progress. Too few of our young people receive undergraduate degrees in science and engineering. According to the data collected by the National Science Foundation (NSF), in 1997, 5.4 percent of all 24-year-olds in the United States received an undergraduate degree in the natural sciences or engineering. In Japan the comparable figure is 7 percent. In Germany it is 8 percent, and in South Korea it is 9 percent.

If undergraduate training in science and engineering were the long-sought silver bullet that ensured rapid technological progress, these countries would soon surpass our technological lead. It is not. There are no silver bullets. But these international comparisons do highlight one area where the United States surely could do better.

Our recent performance also falls short of what we accomplished in the past. In the first seven decades of the 20th century, the United States steadily increased the fraction of the labor force trained as engineers. But since 1970, this fraction has remained roughly constant, despite the fact that these last three decades were, by all indications, a time when technological change steadily increased the demand for skilled problem solvers and knowledge workers.

All observers agree that the university system in the United States is the best in the world. Even if the elementary and secondary school system leaves many children poorly prepared for advanced study, surely the top 8 or 10 percent of the students educated in this system could profitably pursue studies in science and engineering.

Students themselves are interested in science and engineering. Data from the NSF shows that for every two graduates who receive a degree in these fields, there is a third who expressed an intention to major in them but became discouraged along the way. It’s not hard to see why. The grades assigned in science courses are systematically lower than grades in other disciplines, and students rely heavily on grades as signals about the fields for which they are best suited. The introductory science courses are also large, impersonal, and threatening. Students know them for what they are. They call them “weed out” or “weeder” courses.

The key to solving the problem is to recognize that incentives matter on university campuses, just as they do in every other aspect of life. Since World War II, the federal government has substantially increased the incentives for university professors to do research, with dramatic results. Before the war the United States was not a world leader in basic research. Now we are. But in contrast to the practice in many other countries, our government does not give university professors or administrators a financial incentive to train more undergraduate scientists and engineers. Universities have responded by devoting more effort to research and less to teaching.

Without taking any resources away from its support for research, the federal government could create a new arena in which universities and colleges compete for funds. The Tech Talent Bill recently introduced by Sens. Bond, Domenici, Frist, Lieberman, and Mikulski and Reps. Boehlert and Larson shows how this could be done. Institutions would compete for grants on the basis of their success in increasing the fraction of their students who receive undergraduate education in science and engineering. Performance along this dimension is easy to measure and can be closely linked to an easily stated national policy goal. The United States should lead the world in the fraction of 24-year-olds who receive science and engineering degrees.

Because human capital is one of the three key drivers of growth, we know that output per capita will be higher if we have more of the kind of human capital that education in science and engineering creates—the ability to state and solve problems, to quantify what’s at stake, to reason abstractly about causality and counterfactuals.

More important, there is good reason to expect that more of this kind of human capital will lead to more rapid growth in productivity, the most important of the three factors that drive growth. Whatever the private-sector challenge, be it increasing the speed of the next generation of computer chips or refining the logistical systems that move goods from factories to retail outlets, productivity growth will be faster if the people working on solutions have training in science and engineering.

Paul Romer is the STANCO 25 Professor of Economics at the Stanford Graduate School of Business, the Ralph Landau Senior Fellow at the Stanford Institute for Economic Policy Research, and a senior fellow at the Hoover Institution.
Backward Glances over a Traveled Road

To run a business in Thailand, you need patience and flexibility, advises alumnus Jonathan Hayssen, who opened a high-end crafts boutique in Bangkok 12 years ago.

Bangkok, Rasi Sayam has been credited with reviving traditional Thai craftsmanship. The shop’s success has helped transform the way Thais think about interior design and their own culture.

“We had an impact on making Thais appreciate natural things,” says Hayssen, who has been compared to another American, Jim Thompson, who was responsible for the resuscitation of Thailand’s silk industry after World War II. “There was a time when people wanted glitzy stuff—naugahyde, fake leather, and electronics. Thais who were getting wealthy didn’t want things that reminded them of their youth and poverty.” These days the tastes reflected at Rasi Sayam have become “the norms of good taste in Thailand,” Hayssen says.

Establishing a successful and culturally influential business was hardly what Hayssen had in mind when he went to Thailand to work with Mechai Viravaidya in 1981. Better known as “Mr. Condom” in the West, social entrepreneur (and now Senator) Mechai founded the Population and Community Development Association, where he orchestrated revolutionary family planning campaigns that dramatically slowed the country’s rapidly growing population. Hayssen turned down a position with McKinsey to become Mechai’s resident MBa—for $4,000 a year.

Soon afterward, he found himself regularly working at Khao-I-Dang, a refugee camp populated by 150,000 displaced Cambodians, “all with horror stories to tell.” “It’s hard to complain about your $4,000 salary when all these people had their relatives bayoneted in front of them,” Hayssen says.

After working with Mechai for three years, Hayssen established himself as a Bangkok-based management consultant. An assignment with the U.S. Agency for International Development got him acquainted with many of the craftspeople who would later become Rasi Sayam’s vendors.

Twenty years after graduating from the Business School, Hayssen, 47, remembers thinking that if things didn’t work out, he’d simply return to McKinsey, where he had spent the summer while at the gsb. His supervisor there had told him he could “always come back. But if you start working here, two years from now you’ll never take the development job and you’ll always regret it.” Though he deeply enjoyed his summer at McKinsey, Hayssen has no regrets—even though the 1997 collapse of the Thai economy provided plenty of opportunity to rethink taking a path many consider but few actually take.

Thanks to the Thai baht’s devaluation of more than

Having gone far down the path less traveled, Jonathan Hayssen began to wonder if he hadn’t taken a wrong turn. In the heat and humidity of rural Thailand, he had spent an entire day searching for highly skilled artisans he hoped would supply Rasi Sayam, the high-end crafts boutique he was about to open in Bangkok. One prospective vendor had died. Another no one had ever heard of. A third produced goods Hayssen characterized as “disgusting.” Finally, he found one man who had a single basket that met his standards. “This is ridiculous,” Hayssen, MBA ’81, recalls thinking. “Driving through all these villages to wind up buying one basket for a dollar fifty.”

But in the 12 years since he founded Rasi Sayam, which means “radiant Thailand,” Hayssen’s persistence has paid off in many ways. For every dead end Hayssen came across while scouring countless small villages, he also discovered little-known artists of striking talent. More than 200 now sell their products through Rasi Sayam, supporting themselves and as many as 1,000 family members while sustaining a heritage of artistry that was in danger of extinction.

Rasi Sayam’s influence has extended far beyond the individual livelihoods of its vendors. Located in a beautiful wooden home in the upscale Sukhumvit district of Southeast Asia, the shop has been credited with reviving traditional Thai craftsmanship. The shop’s success has helped transform the way Thais think about interior design and their own culture.

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On Guard in Hong Kong

When governor Chris Patten sailed out of Hong Kong in 1997, ending more than 150 years of British rule, he left behind a smoothly functioning civil service. One of its top career professionals was Regina Ip, Sloan ’87, who is currently secretary for security of the Hong Kong Special Administrative Region (SAR).

Professionally, Ip has fared well since the transition: In 1998, Beijing appointed the then-immigration director to her current post. The first woman under either government to head the Security Bureau, Ip is responsible for internal security, law and order, drug control, and immigration. Some 63,000 civil servants and more than 10,000 volunteers serve under her.

But personally, the limelight has proved difficult. Ip has been roasted in the press for what opponents see as hard-line stands on Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red Mainlander immigration and on the Falun Gong. Her critics have dubbed her “Red
hen tony blair became britain’s prime minister five years ago, a key pledge was to transform the hit-or-miss way the country’s financial services sector was regulated. The industry accounts for as much as 10 percent of GDP in the world’s fifth biggest economy. A string of scandals, from the dramatic collapse of Barings Bank following a billion-dollar loss to the misleading of millions of pension buyers, was clear evidence that change was needed.

Britain had been operating under regulations set in 1986, when—somewhat naively perhaps—it was believed that the market would regulate itself and that established-by-statute regulators with real teeth, such as those in the United States, were unnecessary. Ten years and a string of scandals later, it was clear that self-regulation was not working. It was past time for change.

The powers vested in the Financial Services Authority (FSA) were sweeping. In place of a myriad of self-regulating industry bodies, the FSA was established with Davies as its executive chairman, bringing responsibility for the supervision of nearly all niches of the financial services industry under one roof. Davies, then deputy governor of the Bank of England, wound up regulating everyone from door-to-door insurance salesmen to the rocket scientists in the fiendishly complex and rapidly evolving derivatives business.

Although finance types were...
nervous about the creation of such a Leviathan, few in the business criticized Davies’ appointment. First, he was well qualified, not least because the Bank of England had, up to that time, been in charge of the prudential supervision of the banking system, one of the many roles to be centralized at the FSA. Moreover, his considerable experience in the private sector, at McKinsey and Co. (among others), allayed concerns of some who feared the appointment of a chief with a bureaucratic heart poorly attuned to the ways of profit making.

His appointment also put an end to whispers that the top man would be a government yes man, delivering heads on plates at the behest of politicians too eager to grab headlines. Not a member of any party, Davies had been appointed to posts by both the current Labour Party government and its Conservative Party predecessor. He also is known for independent-mindedness, a characteristic that his Sloan Program classmates noted back in 1980. Jean-Pierre Dupret, chairman of Brussels-based firm ROVA, recalls that Davies, despite his relative youth, would not hesitate to take a view contrary to the majority. What’s more, says Dupret, his air of calm authority ensured that others listened.

This willingness to follow his instincts has, at times, ruffled feathers. As head of the government Audit Commission in the 1980s, Davies unsettled some local politicians by taking a tough stance with municipalities that dabbled in derivatives. After his appointment to the FSA in 1997, he raised eyebrows by staying on as president of a high-profile charity for the elderly and continuing as governor of De Montfort University, one of Britain’s largest academic institutes and well known for its close links to industry.

Among consumer groups, his was not an unwelcome appointment. Davies was already a nationally known figure. As director-general of the Confederation of British Industry, the country’s main business lobby group, he appeared regularly in the national media arguing the case for business. Media friendly and unflappable, he cut a figure that the public could relate to, in contrast to the often austere and unbending image of some of his predecessors.

Davies typifies the new generation at the top in a more meritocratic Britain. He was educated in a publicly funded school in Manchester, an unglamorous city in England’s northern half long associated more with declining smokestack industries than financial services. On his own steam he made it to Oxford, the country’s best university. He is married to a highly successful broadcast journalist, and his passion in sport is for soccer, the average guys’ game, rather than rugby, traditionally the field sport of the well-heeled.

Indeed, he spends many of his weekends taking his two teenage sons to see Manchester City, an ever-struggling team that he has been passionate about since his youth. Tom Hayhoe, MBA ’80 and a former McKinsey colleague, recalls Davies’ editorship of the club’s fan magazine in his limited free time at McKinsey. Davies’ appetite for journalism also extended to reviewing books on a range of topics for the Economist newspaper.

Much of Davies’ time at FSA has been spent at institution building, a task made difficult by the need to legislate the FSA into existence in the first place and one that ended up taking longer than anyone had anticipated, Davies included. When the legislation finally took effect last December 1, it had earned the distinction of being the most amended act in Britain’s long parliamentary history.

In an industry as well resourced as financial services, armies of lawyers and lobbyists were hired to pore over the proposals, Davies says. With the FSA granted virtually unlimited power to investigate and fine, firms wanted to be sure some seemingly innocuous clause did not prove costly down the road.

Indeed, one does not have to travel far in London’s financial dis-

tinct today to hear the murmurings. Some go so far as to liken the new body to Frankenstein—made up of many different bits and, ultimately, destined to run amok. Even less excitable souls remain wary, and an eagle eye is kept on anything that looks like empire building.

Davies acknowledges this fear and partly counters it with openness and transparency. In fairness, he has put his money where his mouth is. Last year he took a reduced bonus after admitting that the agency slipped up when okaying an insurance company that subsequently ran into financial difficulties. His manner helps, too. He is clearly a man who is comfortable in his own skin, a characteristic that helps to put others at ease. At the same time, he gives nothing away. He knows exactly the points he wants to get across and uses words and body language to do just that. “Not a single FSA decision has been reversed in the courts, and charges of acting with excessive zeal have been few and far between,” he says pointedly during an interview. But no wonder, say industry sources. “The FSA acts like a judge, jury, and executioner; the costs of seeking judicial review fall entirely on the company that has been accused of wrongdoing,” said one, who, like all others, agreed to speak only on condition of anonymity—a further indication of just how powerful the FSA is.

Once a period of reputation building has been completed, Davies says, those whom the FSA regulates will see his one-stop-shop as saving time and money when they need clearance to enter a new business or launch a new product. Sooner or later, he says, the FSA will enjoy the same high reputation with the public and industry as does, for instance, the U.S. Securities and Exchange Commission.

But to compare the FSA with the SEC may mislead. It is far more than a British SEC with bells and whistles. To get an idea of just how wide-ranging are its powers, consider that it does the work of the SEC (overseeing the business of brokering stocks and trading bonds) along with doing the scrutinizing part of the Fed’s job (keeping tabs on banks) and the states’ insurance regulators (monitoring players in that industry), among others. “The U.S. has more than 70 separate regulatory agencies for our one FSA. Moreover, there are 26,000 people in the U.S. doing the work of our 2,000-strong super-regulator,” says Davies. Even allowing for the difference in size between the two countries, these are efficiency gains.

That said, he does not go so far as to say the FSA way is better. Much has been learned from the American way, he says, but with little statutorily established regulatory infrastructure in place in 1997, his country had to build a structure from the ground up.

Though it may sound strange to American ears, as recently as 20 years ago the financial services industry was cartel-ridden, with laws preventing real competition and practices that had changed little in decades. This was all far too cozy for Margaret Thatcher, the most reform-minded British leader of the past half-century. She ignited the “Big Bang” of 1986, allowing foreign firms in, sweeping away fixed commissions for stock-brokering services and giving banks the freedom to trade in securities for the first time. The liberalizing gales unleashed allowed firms the freedom to innovate and grow. By almost any measure—turnover, profits, or jobs—the industry has grown in multiples. In a number of global niches, such as currency trading, London is the world leader.

But the Big Bang brought losers, too. The slow to adapt went out of business or were gobbled up, usually by U.S. players. (This was the fate, for instance, of all of Britain’s investment banks.) A decade later, global expansion at a gallop was easing the running pains of British banks—while their larger European counterparts were wondering if they could catch up. As bankers stand poised to spread beyond the British Isles, they are acutely aware that the U.S. has finally awakened to the crown jewel of the British economy. Yet they are also aware that the FSA has only just begun to conquer its reputation for bureaucratic heart poorly attuned to the ways of profit making.

With a green light from the new top man, the FSA is now ready to take the next step towards its goal. Davies, who took over in 1997, has been called a calming influence on the regulatory body. That is because the FSA isn’t just about prudential regulation, it is about maintaining trust in the financial sector—hence the creation of the most centralized body in the world. Davies has, at the same time, moved the FSA closer to the new post-crisis world. He has been passionate about since his youth. Tom Hayhoe, MBA ’80 and a former McKinsey colleague, recalls Davies’ editorship of the club’s fan magazine in his limited free time at McKinsey. Davies’ appetite for journalism also extended to reviewing books on a range of topics for the Economist newspaper.

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That said, he does not go so far as to say the FSA way is better. Much has been learned from the American way, he says, but with little statutorily established regulatory infrastructure in place in 1997, his country had to build a structure from the ground up.

Though it may sound strange to American ears, as recently as 20 years ago the financial services industry was cartel-ridden, with laws preventing real competition and practices that had changed little in decades. This was all far too cozy for Margaret Thatcher, the most reform-minded British leader of the past half-century. She ignited the “Big Bang” of 1986, allowing foreign firms in, sweeping away fixed commissions for stock-brokering services and giving banks the freedom to trade in securities for the first time. The liberalizing gales unleashed allowed firms the freedom to innovate and grow. By almost any measure—turnover, profits, or jobs—the industry has grown in multiples. In a number of global niches, such as currency trading, London is the world leader.

But the Big Bang brought losers, too. The slow to adapt went out of business or were gobbled up, usually by U.S. players. (This was the fate, for instance, of all of Britain’s investment banks.) Reflecting wider social change, the once gentlemanly business of finance ceased to be the exclusive preserve of the privileged. In highly competitive marketplaces, merit came to matter more than old school ties and one’s capacity for bonhomie.
This suits Davies, as he is not one of the back-slapping boys. He is an excellent networker and exhibits none of the awkward stiffness for which the English used to be known. At the FSA, dress-down informality has replaced the once obligatory pinstripe suit and starched white shirt of London’s financial districts. When interviewed for this profile, Davies himself was tieless and hiply shod; he personally collected this interviewer from the lobby of the FSA’s shiny, new 15-story home on the banks on London’s Thames. His eschewal of formality goes as far as foregoing the entitlement to be called “Sir” (he was knighted last year in recognition of his work with FSA); Davies is referred to by his first name by everyone from his PA to the security staff.

Davies says he believes the all-under-one-roof approach is especially logical now because of the way the industry is changing. With the lines between different businesses blurring and the consequent emergence of giant financial services groups whose operations include everything from selling pensions and life insurance to running big trading floors, he sees advantages in being able to gather experts quickly if questions arise about a firm or industry. Indeed, the stability of the financial system depends on the speed with which he can muster his forces at a time of crisis—for example, the collapse of Long-Term Capital Management, a U.S. hedge fund, in 1998.

The LTCM debacle also illustrates yet another benefit of the single-regulator approach. The financial services industry is not only among the most globalized of industries but is itself an engine of the globalization process. This means regulators in different jurisdictions need to be in almost constant contact. Davies says he believes that a single super-regulator smooths the interface between authorities in different countries.

Apart from the bilateral ties, the FSA is involved in many forums that seek to do everything from cutting down on money laundering to redesigning the architecture of the international financial system. Indeed, Davies chaired a G-7 committee that recommended a series of measures to strengthen the foundations of the world’s financial system.

Another foreign connection is the United Kingdom’s membership in the European Union, Europe’s experiment in merging its national economies and some of their political functions. But creating a single European market in financial services, particularly in sectors such as life insurance and asset management, has proved difficult to achieve, a constant reminder of the difficulties of welding together different regulatory practices and traditions.

The September 11 attacks in the United States mean that cooperation is a matter not just of economic security but also of physical security. As a result, contacts between regulators have reached a new intensity. Davies expresses a deep sense of personal shock at the attacks, in part because of the closeness of New York and London, often said to be sister cities owing to the connectedness of the world’s two preeminent financial centers—links that were so tragically evidenced by the 53 Britons who died or are still unaccounted for in the attack on the World Trade Center.

Davies moved quickly to look for evidence of suspicious transactions in the days before the attacks but found none. A longer-term effort is under way to strangle the financial networks of terrorist groups. Legislation went into force in December giving the FSA greater powers to combat money laundering. It now can fine financial institutions that fail to ensure that their clients’ money is clean. More informally, increased information exchange on suspicious transactions already is taking place as the world learns to live with the threat of terrorism on a previously unimaginable scale.

The FSA also is dealing with the potentially destabilizing effects of mammoth liabilities incurred by the re-insurance industry. The sheer scale of the September 11 destruction, Davies says, raises new questions about precisely what is and is not insurable and about the balance sheet positions of some of the biggest re-insurers. He says that his agency is keeping an eagle eye on the sector, using experience gained during the 1990s when London’s financial district was devastated on a number of occasions by terrorist truck bombs and paid out hundreds of millions of dollars.

An age of hyperterrorism has seen premiums being jacked up, particularly for airlines, improving insurers’ cash positions and, Davies worries, possibly lulling some of them into a false sense of security, as it remains unclear at the time of writing as to the size of the payouts and on whom they will fall.

As the interview wraps up, Davies expresses optimism that with regulatory practices being constantly improved, there are multiple benefits. Not only does good regulation cut down on opportunities for criminals and terrorists, but it also attracts the best business. With London still head and shoulders above any of its Continental European competitors as a financial services center, at least some credit must go to the man who has been at the helm of the FSA since its launch.
We encounter markets every day in countless ways: in our buying and selling, working and investing. We can glean insight, however, by taking a fresh angle on the familiar.

This is a riposte to McNealy’s challenge. Current research by economists is deepening our understanding of markets. These new ideas in economics, and some old ones, are used in what follows to dissect exotic, innovative, and everyday marketplaces: some in physical space, others in cyberspace.

Markets are subtle organizations. This is one of my themes. The mechanisms that underpin transacting are intricate—and they are in everlasting flux. People are ingenious at finding ways to make exchanges that bring mutual gains.

Markets do what they are supposed to do, however, only if
they are well structured. Any successful economy has an array of devices and procedures to enable markets to work smoothly. A workable platform for markets has five elements: information flows smoothly; property rights are protected; people can be trusted to live up to their promises; side effects on third parties are curtailed; and competition is fostered.

Even the simplest markets reveal surprising subtleties when you look at them up close. Consider the Makola marketplace in the center of Accra, Ghana, as described by Claire Robertson, an Africanist scholar. The stallholders, who are mostly women, sell fish, vegetables, grains, canned foods, and basic household items. They operate on a tiny scale, a typical day’s turnover being just a few dollars. The marketplace, housed in several large dirt-floor sheds, is overcrowded and dusty. The press of people, the noise, and the smell of fish overwhelm a visitor.

First impressions are misleading. Primitive as it may look, the Makola market is an intricate system. The stallholders are not just retailers but also wholesalers: They buy in bulk to sell small quantities to consumers, and they aggregate small purchases for resale to other sellers. They organize transportation of goods—not a simple matter in a country with inadequate roads and railroads—serving as intermediaries between widely scattered producers and consumers. They do some rudimentary manufacturing: crafting with beads, and processing raw materials into foodstuffs, condiments, and cosmetics. They find recycling uses for cans, bottles, and newspapers. Assessing their customers’ creditworthiness and
granting some of them credit, they take on the role of banks. Being illiterate, the stallholders must keep their business records in their heads, using impressive powers of memory. They make precise calculations of their input costs to keep track of their profits. The price for a string of beads, for example, reflects the price a vendor paid for the beads and thread, the time she or her employee spent stringing the beads, and her target profit margin.

The stallholders have developed their own miniature legal system. Informal property rights have arisen. Although they do not have legal title to their stall space, which is technically owned by the Accra city council, they act as though they do. Spaces are inherited. Often the current stallholder acquired the space from her mother or sister. Spaces are also rented, bought, and sold. Certain respected merchants called “queen mothers” play the part of judges, arbitrating when disputes arise.

The Makola marketplace has continued to operate despite periodic, sometimes violent attempts by the Ghanaian government to shut it down. These attempts reached a height of brutality in 1979 after the military government accused marketplace traders of violating its price controls. Soldiers looted the stalls and then dynamited the marketplace. Later, in the town of Kumasi, soldiers armed with machine guns raided the marketplace and beat up the traders. Accusing one of profiteering, a soldier ripped her baby off her back and shot her. Bulldozers then ground the marketplace stalls into the dust. A soldier remarked, “That will teach Ghanaian women to stop being wicked.”

The Ghanaian government, invoking the “market women menace,” was using the merchants as a scapegoat for its own policy failures, which had led to severe shortages and inflation. Newspapers parroted the government’s line. One described the market demolition as a “happy tragedy,” which produced “tears of joy in the worker, the common man,” who was “helpless at the hands of the unfeeling Makola conspirators” (that is, the vendors).

With a week the merchants were back where their stalls had been, selling their fish and their vegetables, though now without a roof over them. The Makola traders’ accomplishments, Robertson says, “have been triumphs of intelligence, determination, and sometimes desperation.”

At the Internet auction site eBay, bidders feverishly compete for everything from junk to high art. It all began in 1995 when Pierre Omidyar set up a Web site called AuctionWeb for people wanting to exchange information about collectibles and to make trades. Legend has it that his initial goal was to sell his girlfriend’s collection of Pez dispensers. The site’s services were initially offered free of charge, as a service to the public. After six months’ explosive growth in usage, based on word-of-mouth recommendations, Omidyar began charging a fee, a small percentage of the sale price, to cover his costs of running the Web site. Payment was left up to the honesty of the seller, but the checks rolled in. He gave up his day job and was joined in the firm by Jeffrey Skoll, MBA ’95. Together they developed the auction software and the customer-support infrastructure. “We would work virtually anywhere we could find an office,” recalls Skoll. “We started off in Omidyar’s living room, then we moved to my living room.” They initially contemplated focusing on a particular market segment, such as coins or stamps. “In the early days, our strategy changed by the day,” says Skoll. They finally decided not to specialize, but to let anyone sell anything.

With the auction system reengineered to handle the massive volume of traffic, they relaunched AuctionWeb as eBay in September 1997. Less than two years later, eBay’s stock market value reached $22 billion. The business press proclaimed eBay’s reinvention of markets. Business Week reported that, with its online auctions, “eBay has single-handedly created a new market.” According to the Economist, “Internet auctioneers such as eBay may be the instigators of a revolutionary leap forward in the efficiency of the price mechanism.”

The eBay Web site is a high-tech flea market. It has over 10 million registered users; the typical user spends 20 minutes a day on the site. Around 1 million auctions are running on any given day, selling everything from cast-offs to fine art. As I write this, there are, for example, nearly 1,500 items listed under the heading “Victorian tradecards”—which, it turns out, are a 19th-century version of junk mail.

eBay has created a global market for goods that previously had a purely local market. One of the secrets of eBay’s success was in recognizing that the Internet, by making it easy for buyers and
sellers to get together, created new possibilities for trading knickknacks of all kinds. The other secret of its success was in building a user-friendly and flexible auction mechanism. Pre-Internet auctions had the disadvantage that they required the potential buyers to assemble in one place. (Bids were sometimes made by fax or telephone, but this was clumsy.) Bidders in an eBay auction get together only in cyberspace.

Ebay lowered the costs of transacting enough that people anywhere wanting to trade low-value items are able to deal directly with each other. Its popularity induced others to start offering Internet auctions. Now, at hundreds of different auction sites, people bid for computer equipment, antiques, fine art, stamps, toys, jewelry, travel services, real estate, and wine. Ebay showed that the Internet and auctions were made for each other.

What do the eBay founders have in common with the Makola merchants? Each set up exchange mechanisms to generate gains from trade. Where markets are absent, mutual gains can be realized by establishing them. Where markets are present, further gains are sometimes to be had by finding ways to make them work better. People have forever been devising new markets and improving existing ones.

While the Internet has linked people more closely than ever before, this is not the first or even the biggest such transformation. Earlier advances in communications technology had a similar effect in broadening markets. Entrepreneurs were improving markets long before the Internet came along. “The telegraph and the printing press,” observed the magazine Contemporary Review in 1886, “have converted Great Britain into a vast agora, or assembly of the whole community.” The postal service, the railroads, the telephone, and radio and television all in their own way transformed communications. In his 1847 Principles of Communism, Friedrich Engels remarked of the industrial revolution, “Big industry has brought all the people of the earth into contact with each other, has merged all local markets into one world market.”

Engels was not enamored of the reinventing of markets, of course, but it is inexorable. Potential gains are missed if a transaction cost of some kind impedes buying and selling, so there is a profit opportunity in finding a way to lower that cost. Novel market devices appear. Someone may design a whole new marketplace. Or, through the separate actions of many, the market’s rules and procedures may gradually emerge.

Modern markets are sophisticated organizations. Markets for multifaceted products like automobiles and computers, and for labor and financial services, must solve a range of problems that may not arise with simpler items like clothing and food. A market works well only if information flows smoothly through it. An uneven distribution of information hinders negotiations and limits what can be contracted. Information transmission requires devices that ensure the communications are reliable. A market works well, also, only if people can trust each other. Trust requires mechanisms to bolster it since, regretfully, not everyone is inherently trustworthy. Many goods have hidden characteristics, so there must be some way of assuring buyers of the goods’ quality. Trust is needed also in transactions that take time to complete. People are reluctant to invest in the absence of some assurance that the others’ promises will be kept. A modern market economy needs a platform sturdy enough to support highly complex dealings.

Some invoke the supernatural to explain what they find extraordinary: that markets can work with no one in charge. The Rev. Richard Whately, a professor of political economy at Oxford University in the 18th century, believed the coherence of the market to be proof that God exists. If no human planner is guiding the market to the optimal outcome, God must be. The invisible hand is the hand of God.

A religious fervor characterizes some of today’s fans of the free market. “The true spirit capital of the current capitalist economy is not material. It is moral, intellectual, and spiritual,” declared George Gilder, an evangelist for libertarianism. He also said that entrepreneurship “most deeply springs from religious faith and culture” and that entrepreneurs “embody and fulfill the sweet and mysterious consolations of the Sermon on the Mount.” Ronald Reagan liked to use the catchphrase “the magic of the market”—inadvertently bearing out the jibes about his “voodoo economics.”

Carlos Fuentes, the novelist, derided what he calls economic fundamentalism, “with its religious conviction that the market,
Markets are too important to be left to the ideologues. In fact, markets are the most effective means we have of improving people’s well-being. For poor countries they offer the most reliable path away from poverty. For affluent countries they are part of what is needed to sustain their living standards.

A workable market design keeps in check transaction costs—the various frictions in the process of making exchanges. These include the time, effort, and money spent in the process of conducting business: both any costs incurred by the buyer in addition to the actual price paid, and any costs incurred by the seller in making the sale.

Markets provoke clashing opinions. Some revile them as the source of exploitation and poverty. Others extol them as the font of liberty and prosperity. There is the dogma that markets are inherently harmful, so they should be routinely overridden by the state; and the dogma that markets are unambiguously beneficial, so we can leave everything to the free market. “For every problem there is a solution,” said H.L. Mencken, “that is simple, direct, and wrong.” Both of the simple, direct solutions regularly offered for all kinds of societal ills—“suppress the market” and “leave everything to the market”—more often than not are wrong.

“Find me a one-armed economist,” President Herbert Hoover ordered, out of frustration with economic advisers who kept saying, “On the one hand … on the other hand … ” Honest answers to the big questions in economics, however, are rarely free of caveats. On the merits of markets, most economists are unapologetically two-armed.

Markets are too important to be left to the ideologues. In fact, markets are the most effective means we have of improving people’s well-being. For poor countries they offer the most reliable path away from poverty. For affluent countries they are part of what is needed to sustain their living standards.

Markets, then, are the most potent antipoverty engine there is—but only where they work well. The caveat is crucial. Over a billion Africans and Asians, according to the World Bank, eke out a living of sorts on one dollar or less a day. That is more people than live in the affluent West. For a great many, it would seem, markets are not doing much good.

Governments in poor countries sometimes intervene excessively, stifling markets and exacerbating the poverty. But that is not the entire story. If the state were to cease its counterproductive interventions, those countries would remain poor. In Calcutta or Cairo or most other third-world cities, markets operate everywhere. You can’t steer clear of peddlers eager to sell. The problem is not that markets are absent; it is that they are working badly.

Left to themselves, markets can fail. To deliver their full benefits they need support from a set of rules, customs, and institutions. They cannot operate efficiently in a vacuum. If the rules of the market game are inadequate, as often they are, it is difficult and time-consuming to set them right. Many countries, to their citizens’ detriment, have not yet been able to do so.

Markets are not miraculous. There are problems they cannot address. If their platform is unsound they do not even solve the problems they are supposed to solve. Viewed as tools, markets need be neither revered nor reviled—just allowed to operate where they are useful.
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Banking Scholar Awarded Sloan Grant

Manju Puri, associate professor of finance, has been awarded an Alfred P. Sloan Research Fellowship, an honor that carries a $40,000 grant. Puri’s work has focused on financial intermediation, particularly banking and venture capital.

Sloan research fellowships, awarded for two-year terms, recognize young scientists who show outstanding promise of making fundamental contributions to knowledge.

Puri’s research in banking has centered on the conflicts of interest banks face in serving as both securities underwriters and lenders to companies, and how their role compares to that of investment banking firms, which serve only as underwriters. Her papers on universal banking and the implications for Economic Management, because that agency “has responsibility for most economic policy in Vietnam.”

The Université Paris-Dauphine, one of the institutions that comprises what was formerly known as the Sorbonne, has awarded David Kreps an honorary doctorate. The November award ceremony was held in the legendary “war room” of the converted NATO headquarters that now houses the prestigious university.

Kreps is the School’s Paul E. Holden Professor of Economics and a senior associate dean for academic affairs. He is known for his pathbreaking work in dynamic choice behavior and economic contexts where dynamic choices are key. Among his many contributions to the literature of financial economics and dynamic games, he has authored a widely used graduate-level textbook on economic theory.

George Parker, who has served the Business School and University in more roles than he can count, was honored by gsb faculty recently with the Robert T. Davis Award, recognizing his extraordinary contributions to the School.

Parker, the Dean Witter Professor of Finance and Management, first came to the School in 1960 as an MBA student and returned in 1965 to study for a doctorate. He taught at Columbia University and worked at a venture capital firm before joining the gsb faculty in 1973 to teach finance and direct the Sloan Program. Most recently, he directed the MBA Program.

Dean Robert Joss described Parker as an “irrepressible, enthusiastic, and tireless ambassador for the School”; a great teacher, communicator, and adviser to young people, deans, and university presidents. Former Davis Award winners James Van Horne and Charles Holloway agreed with Joss, but they picked apart Parker’s skills as a student and cowboy.

Parker drove Van Horne crazy with questions when he was in his finance class, Van Horne recalled. “Like the Energizer Bunny, he never really wore down.” Holloway regaled other faculty with his stories of Parker’s mishaps on horseback, including the time Parker returned to the barn covered with the molasses that he had intended to use as a lure to catch his horse.

The Davis Award was created in memory of Professor Robert Davis to honor a lifetime of achievement at the School.

Faculty member J. Michael Harrison has been honored with the 2001 Frederick W. Lanchester Prize of the Institute for
Operations Research and Management Science (INFORMS), the leading professional and scholarly organization devoted to operations research and the management sciences. The prize annually recognizes the best contribution to the discipline published in English and includes a commemorative medal and a $5,000 cash award.

Harrison, the Gregor G. Peterson Professor of Operations Management, was recognized for a series of four papers appearing between 1988 and 2000. The papers discuss problems of resource allocation in “processing networks”—examples include manufacturing systems, communication networks, product development systems, and service operations like insurance claims processing. Harrison develops a novel method of redeploying available capacity in the face of chance events; for example, when equipment fails or when demand surges in manufacturing.

Margaret Neale was elected to the Fellows Group of the National Academy of Management at its annual meeting held in August. She is one of 159 members of the 11,000-member academy who have been honored for their “significant contributions to the science and practice of management.” Neale is the John G. McCoy–Banc One Corporation Professor of Organizations and Dispute Resolution. Her research and teaching focus on negotiation and decision making, collaboration, the allocation of burdens and benefits, learning in groups and teams, and diversity. Other members of the Business School faculty who have been named fellows of the management academy and the year in which they were named are Jeffrey Pfeffer, 1986; James March, 1988; and Joanne Martin, 1993.
Measuring Executive Accountability

Over the past decade, companies increasingly have been called on to create more value for their owners. Led by aggressive institutional shareholders like the California Public Employees Retirement System and fueled by widely published reports of overcompensated executives, shareholders are demanding that managers be given incentives to focus on corporate value creation. Consulting firms have responded with a host of new performance metrics. Some of the most popular are known as “economic value added,” “flow return on investment,” and “economic profit.”

Economic value added has become so popular a concept that its acronym actually has been trademarked by consulting firm Stern Stewart & Co. Still, it’s not really new. “The concept has been known for quite some time in the accounting literature as ‘residual income,’” says Reichelstein. “It’s really a very simple formula: accounting income, properly measured, less a capital charge for the assets used by that particular business or division.

“In contrast to ordinary accounting income, residual income is fundamentally compatible with present value considerations. That aspect in turn is critical in motivating managers to make long-term decisions that enhance the overall net present value of the firm.”

Which is all well and good. But the problem remains that managers may not be willing to engage in projects that increase value way down the line, value that isn’t measured—and therefore rewarded—now. “This is where the accounting rules come in,” Reichelstein says. “Good accounting rules allocate current and expected future cash flows to reflect value creation in the performance measure early on and consistently over time. That way, it is of less importance whether managers have shorter planning horizons than shareholders.”

Economic value added and similar formulas proposed in the “war of the metrics” all make adjustments to the accounting rules used for external financial reporting. But which of these adjustments is most effective in aligning the objectives of managers and shareholders remains a subject of lively debate.

In a paper that won the Best Paper Award at the Review of Accounting Studies conference last year, Reichelstein and Sunil Dutta, assistant professor of accounting at the Haas School of Business, University of California, Berkeley, analyze a model that compares the effectiveness of alternative performance metrics and accounting rules. The study, “Controlling Investment Decisions: Depreciation- and Capital Charges,” focuses on capital investment decisions and the choice of depreciation method to account for these investments.

Dutta and Reichelstein establish that residual income is indeed an efficient performance metric. When combined with particular depreciation schedules, residual income can align the objectives of shareholders and management consistently over time. In general, these depreciation schedules will differ from the common straight-line method used for external financial reporting purposes. The model analysis also shows how the capital charge rate used for performance evaluation should vary with the riskiness of the investment project.

For other assets, such as receivables, inventory, or multiyear construction contracts, similar issues arise. Reichelstein and Dutta broaden their inquiry in a relat-

“The setting in this paper is richer,” says Reichelstein, “in that you can base performance evaluation on both stock price and the accounting numbers. Stock price obviously is what shareholders ultimately care about. From a performance evaluation perspective, however, one drawback of stock price is that it aggregates all value-relevant information even though some factors are beyond the manager’s control. Accounting-based performance measures can mitigate that problem, and therefore you want both.” In this second paper, the authors identify the need for performance measures that are calculated as a properly weighted average of market value added and economic value added.

There is growing evidence that value-based management does deliver for shareholders. Reichelstein and his colleagues in academia predict that further analytical and empirical research will explain why and how. They believe that the interest in these metrics isn’t likely to lessen. After all, Reichelstein says, “People in the field realize the old adage that ‘whatever gets measured also gets delivered.’” — J A N E T Z I C H


Global Economics

Don’t Put the Blame on Trade Liberalization

A ntiglobalization protests took a violent turn when the World Trade Organization met in Seattle in 1999. Impassioned activists blamed trade liberalization policies in developing countries for a variety of ills. Chief among them were the claims that such policies have an adverse impact on countries’ growth rate and that increased trade leads to tectonic shifts in labor sectors—e.g., from agriculture to manufacturing—that result in a multitude of problems such as the displacement of large numbers of workers, the abandonment of traditional ways of life, a deterioration of the environment, and massive unemployment.

“Trade economists know that a country opening up to trade will specialize in certain sectors, putting resources into producing goods and services that are more efficient, and abandoning those that are relatively inefficient,” says Romain Wacziarg, assistant professor of economics. “That’s called comparative advantage.” It is why some structural realignment can be expected in a country’s workforce after liberalization of trade.

To Wacziarg’s surprise, his recent research uncovered little or no evidence of shuffling of workers in the aftermath of trade liberalization. “I thought I would be able to quantify which sectors grew or diminished,” he says.

Wacziarg and coauthor Jessica Seddon, a doctoral student at the gsb, compared statistics—such as head count before and after liberalization—from 26 developing countries that had clear and discernible breaks in their trade policies.

Using information consistent across countries, Wacziarg and Seddon found very little change in the structure of labor sectors within five years of liberalization; what shifts did occur were either small or not statistically significant. “In general, countries like Poland that have very flexible labor markets where laborers are allowed to move around tend to have more movements. And countries like Spain that tend to use regulations to create safety nets, for example, that prevent workers from being fired, have less movement,” says Wacziarg.

Domestic policies to offset potential shocks to the labor market are one explanation for the unexpected lack of labor migration. These measures also tended to actively counter the positive effects of liberalization.

“If a country removes a tariff on a good, for example, it’s going to start competing with goods from foreign countries because foreign goods can now enter the country at a competitive price,” Wacziarg says. “So to remedy this, governments enact domestic subsidies to the industry to restore the competitive advantage, which had been lost with tariffs.” He cites the Philippines in 1988 and Turkey in 1990 as examples.

“It’s clearly not the case that you have the post-liberalization sector-level upheaval that activists claim,” he says. “If it happens, the shuffling can take something like 20 years, and that’s much less of a problem and allows workers to be retrained.”

In a separate, related study, he found countries that adopted open trade policies did experience measurable gains in economic growth. Examining the link between trade policy and economic growth in 57 countries from 1970 to 1989, Wacziarg developed an index for measuring trade policy openness and found that every 10 percentage-point increase in the ratio of trade to gross domestic product resulting from changes in trade policy alone is associated with a 0.67 percentage point increase in a country’s annual growth rate.

“If you compound that over several years, the consequences for a country’s average per capita income can be far-reaching,” he says. “The implications of this for a country like China are enormous, just because of its sheer size. Add in India, another country with vast potential, and something like four-tenths of the world’s population could yet benefit from greater openness to international trade.” — H E L E N K. C H A N G


When trade policies are liberalized, it can take years before workers are affected—enough time to allow them to be retrained.
News media are often criticized for covering presidential campaigns as if they were horse races and for predicting the winner before the polls close in all states. A new study suggests that some voters indeed might be influenced by predictions of who is likely to win. Surprisingly, it is the most partisan voters—not the undecideds—who are most likely to become more favorably disposed toward a leading candidate whom they initially opposed.

In the week immediately preceding the 2000 U.S. presidential election, graduate students Aaron Kay and Maria Cristina Jimenez polled 288 people in the San Francisco Bay Area in collaboration with associate professor of organizational behavior John Jost. They asked people at shopping malls, airports, and on campus to evaluate candidates George Bush and Al Gore after reading a purportedly authoritative analysis of the election’s likely outcome. Some respondents read that experts expected Bush to win by a wide margin, others read he would win narrowly, while still others read predictions of a Gore landslide, narrow victory, or a tie. Participants were then asked to rate the desirability of both Gore and Bush presidencies on a scale of 1 to 9 and also to indicate their own party affiliation.

Overall, the results showed a strong relationship between a candidate’s perceived likelihood of winning and his desirability to voters. That is, both Republicans and Democrats tended to rate Gore as more desirable as the probability of his victory increased and to rate Bush as more desirable as the likelihood of his victory increased. Both candidates also were rated less favorably when they were believed to be losing.

People apparently have a “remarkable tendency to adapt and accommodate to anticipated outcomes, even if those outcomes are not personally good for them,” says Jost, who studies how institutions gain and lose legitimacy and who coedited the book The Psychology of Legitimacy. “This tendency may help to explain why social and political systems are as successful as they are at retaining cooperation and consent and why qualitative social change is so difficult to accomplish,” Jost says.

However, evidence from this field study and a follow-up experiment conducted by the three researchers clarified that not everyone adjusts his or her views to fit the anticipated outcome. The people polled who said they were political independents or from a third party did not increase their evaluations of the likely winner, whether it was Bush or Gore.

In a second study, the researchers asked undergraduates to rate the desirability of either large or small tuition increases or decreases that were perceived as likely or unlikely. Thus, there were eight different conditions in the experiment. Here again, those who learned that a large increase was highly likely were far more likely to rate it as desirable compared with those who thought the large increase was not very likely or with those who were told a much smaller increase was probable. These results prompt Jost to suggest that people only rationalize outcomes in which they are psychologically invested.

“People adapt to anticipated outcomes, even if those outcomes are not personally good for them. When outcomes are highly consequential and at the same time highly uncertain, people face an interesting psychological dilemma,” he says. “They hope for the best but must also prepare themselves for the worst. As undesirable events are perceived as more likely, people rationalize anticipated outcomes. Events that are perceived as more likely come to be seen as more desirable—as sweet lemons—and those perceived as less likely come to be seen as less desirable—or as sour grapes.”

Nonpartisans probably did not jump on the predicted winner’s bandwagon in the polling experiment, Jost says, “either because they had no strongly preferred candidate or because they knew that their third party candidate had no chance of winning.” Thus, they were not motivationally involved in the outcome of a Bush–Gore contest. Similarly, students facing the likeli-
Venture Funding Signals Growth Strategy

**Limited resources, lack of market history, and inability to widely communicate product quality make it difficult for most startups to survive.** Prior research indicates that venture capital funding is the most significant resource for entrepreneurial success—it allows for faster product-to-market turnover and enables a company to “professionalize” management teams quickly. (See Stanford Business, “Making Startups Grow Up,” February 2001, and “Venture Capital: More Than Money,” June 1999.)

But how much does the amount of funding or its timing matter? New research by gsb faculty suggests that initially the amount is less important than the fact that venture funds were invested at all. Later on, the amount and timing significantly affect a startup’s growth path.

“There is a big difference in the relationship between venture capital firms and startups in early rounds of funding compared to later rounds,” says Antonio Davila, assistant professor of accounting and Morgridge Faculty Fellow in Entrepreneurship for 2001–02. “In early rounds, the startup needs money to think and try things. Money allows you to fund the ‘idea generation process.’ In later rounds, you have to implement a specific strategy.”

Early-round funding is typically used to increase a company’s intellectual capital by hiring new employees as well as bringing existing employee salaries up to the market average, Davila says. Later-round funding allows venture capital firms to more directly affect the specific strategy of a startup company’s growth. VCs invest less cash when they want to guard against growth that is too aggressive and more cash to assist in faster growth than a startup could fund on its own.

Overall venture capital activity grew from $2.3 billion in 1990 to $140 billion in 2000, according to Venture Economics. But it’s not the nineties anymore, and the economy is suffering a heavy dose of reality. As Davila says, being a venture capitalist is like playing for the NBA. “In the nineties everybody thought, ‘I could be Michael Jordan.’ But the truth is that most people are not Michael Jordan.”

To reach their conclusions, Davila and his coauthors, Stanford colleague George Foster and Mahendra Gupta of the John M. Olin School of Business at Washington University in St. Louis, began by analyzing payroll data from 606 entities covering January 1994 through May 2000. The data were useful in determining the effects of specific funding rounds on company growth.

The team examined both the number of employees and average salaries around the timing of financing events and compared the amount of funding made available. The results indicated that the average salary is lower before early rounds than at any other point, which is consistent with the financial constraints of startups. And in early rounds, the specific amount of funding is not as important to growth as the fact of the funding itself. In later rounds, growth happens both before and after the funding event, which suggests that later-stage startups have the resources to grow, as soon as the signal of an upcoming round is credible enough. And in later rounds, the amount of funding has a significant impact on the subsequent growth strategy of the company.

Davila and his colleagues use signaling theory developed by retired gsb dean A. Michael Spence, one of last year’s Nobel laureates, to explain some of their results. Each funding event communicates information internally to the employees and externally to the larger market. The researchers measured the internal signal by tracking employee turnover and found that in early rounds, turnover significantly decreased before the funding event, which suggests that the signal has credibility even before the salaries go up. “Employees start to believe that it will happen (not necessarily through a public announcement but simply because of the comments in the company) and decide to stay in the company. Believing that is going to happen is what we call the credibility of the signal,” Davila notes. “It tells the employees, ‘Hey, we’re a good company.’”

How should entrepreneurs take advantage of this information? Davila cautions them: “When you think about a venture capitalist, you shouldn’t think, ‘I’m getting money,’ as if you were going to a bank, and it doesn’t matter which bank. Here it makes a lot of difference, because the venture capital investment firm is going to affect the way you implement your strategy and the way you grow your company.” —Lisa Eunson


Vcs invest less cash to guard against growth that is too aggressive, and more to assist in faster growth.
From Rocks to Stocks
SHE HAS A DOCTORATE IN mineralogy, but Viola Sanvordenker, Sloan ’84, became fascinated with investments when she followed her father into the Hong Kong Futures Exchange in the 1970s. Now a fee-only financial planner working from her home in Citrus Heights, Calif., Sanvordenker recently was named Woman of the Year by Sacramento’s Downtown Capitol Business and Professional Women. Financial planning is an excellent field for women, she told the Sacramento Bee, because more women are seeking financial counseling, and many of them “don’t relate well” to male financial planners.

Professor Chides Cancer Institute
BUSINESS SCHOOL PROFESSOR Jeremy Bulow took the National Cancer Institute to task for distorting the facts in a recent Forbes essay titled “The Anti-tobacco Jihad.” If a private company distorted scientific claims similarly, it would be prosecuted, writes Bulow, who directed the Bureau of Economics at the Federal Trade Commission during the Clinton administration. Bulow agrees with the Institute that “smoking kills” but says the agency’s latest monograph on cigarettes claims that light or low-tar cigarettes are no safer than regular cigarettes, despite research to the contrary.

On Watch @ Marketwatch
WITH WIDE-RANGING experience in news media, Kathleen Yates, MBA ’81, was recently named president and chief operating officer of Marketwatch.com Inc., one of the leading providers of financial news on the Web and also a provider to television and newspapers. Marketwatch.com quoted Yates as saying she saw “great potential for new revenue growth” in the company. Yates cofounded a technology firm called ITPro Inc. and has been a vice president in Knight Ridder’s news media division and at Women.com Networks.

Some Like It Steep
DESCRIBING HIS CAREER as “nothing if not bold,” the Baltimore Business Journal named Mayo A. Shattuck III, MBA ’82, its Businessperson of the Year for 2002. An investment banker at Baltimore’s 200-year-old Alex. Brown until September, he felt the firm was too small to survive a global shakeout, so Shattuck led it through two mergers in the 1990s, including a 1999 sale to Deutsche Bank AG. Last October, he was named president and CEO of Constellation Energy Group Inc., a new field for him. Analysts said his banking experience would come in handy, and Shattuck said he relishes “steep learning curves.”

Dig Deeper Than Your Checkbook
“WRITING A CHECK is only the tip of the iceberg,” Laura Arrillaga, MBA ’97 and a lecturer at the GSB, told the San Jose Mercury News in a recent article about the new breed of non-profit giving circles. Arrillaga founded and cochaired Silicon Valley Social Venture Fund, $v2, a group that has raised more than $1 million for social causes. Its 135 members are expected to donate their time and expertise as well. Members include Mayfield Fund partner Kevin Fong, MBA ’82, and former eBay president Jeff Skoll, MBA ’95.

Hospital exec Andrew Agwunobi wants to create a classless culture.
Being Small Relies on Big Support

Calling the gsb’s educational programs “intense, intimate, and life-changing,” the Financial Times asked Dean Robert Joss to explain why the School chose to keep its programs smaller than those of its competitors and how it could afford to do so.

The general management knowledge taught by faculty “scales well in terms of ideas,” Joss said. “What we haven’t figured out is how to scale the learning experience. You can televise or stream the class, but it does not replicate the experience.”

The gsb’s model of education “will not pay for itself on a user-pays, upfront basis,” Joss explained. “It relies on people being willing to pay throughout their lives. We rely on one generation feeling responsible for the next to keep it going. It’s not an easy model, and it’s not without risk.”

Risk Is Relative

Entrepreneurship may seem more risky than corporate consulting or banking jobs, but gsb faculty member Irv Grousbeck “asks his students to compare the risks of entrepreneurship with the slim chance that they’ll ever become partners at a large firm,” according to an article in Fortune Small Business.

Grousbeck and a partner pooled $3,500 in 1964 to start a small cable TV company. Continental Cablevision had become one of the biggest cable companies in the nation when he stepped down as president 16 years later.

Building the New China

“If my grandmother found out what I’m doing, she would probably jump out a window,” Eric Li, MBA ’95, told the San Jose Mercury News. Li is cofounder of a Shanghai-based venture capital firm, Chengwei Ventures, and one of the “sea turtles,” as Chinese call citizens who were educated abroad and are now being lured back by China’s strong economy and entry into the World Trade Organization. Raised in a Shanghai house shared by four families, Li said his family valued scholarship and government service, not entrepreneurship.

Globalization Critic

One day in 1992, David Korten looked out his Manila office window and saw the diesel-polluting cars of multinational executives on the clogged street below and a few blocks away people living in shacks atop a garbage dump. After three decades training business managers in Africa, Central America, Asia, and at Harvard, he decided instead to become active in the antiglobalization movement.

In October, Worth magazine listed Korten, MBA ’61 and PhD ’68, as one of the “100 people who have changed the way Americans think about money.” Critics call him a misguided idealist, but his 1995 book, Why Corporations Rule the World, and speeches provide intellectual backing to groups who have protested at meetings of the World Trade Organization. Korten told the New York Times he attended the gsb because he believed modern business management would help impoverished countries, but he gradually came to believe multinational companies aren’t accountable and hold tyrannical power over the future of underdeveloped countries.

Fattening Up in a Downturn

“People are realizing that to get out of the downturn you don’t just need a puny version of the organization you had before. You actually need to do some new stuff,” says Robert Sutton, a professor at the gsb and the School of Engineering. Speaking to the Financial Times about the counter-intuitive ideas in his new book, Weird Ideas That Work, Sutton cites Sun Microsystems and Intel Corp., as examples of companies that spend more on research and development as they are cutting jobs in manufacturing. Companies need to strive to fail the way Procter & Gamble does, Sutton says. The shampoo and detergent maker strives to test 10 ideas in the supermarket rather than kill them off in development, he says, because it does not know which of the 10 won’t fail.

Critical Turnaround

“We made it through the valley of the shadow of death,” William McGlashan Jr., MBA ’90, told the New York Times in January when the venture capitalist moved from acting to permanent CEO of Critical Path Inc. Once a high-flying provider of corporate email systems, the San Francisco-based company first ran into trouble in January 2001 when it widely missed earnings projections. The next month, it suspended two top executives, and the Securities and Exchange Commission launched an investigation of its accounting practices that eventually forced a restatement of earnings.

McGlashan was brought in as a turnaround specialist, and the company secured a $95 million bailout from investors in November that allowed it to quietly settle more than 50 shareholder lawsuits. The newspaper quoted one analyst who called it a “remarkable pullback from the abyss.”
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Dynamic Supply Chain Management

Professor Margaret A. Neale
Setting Us Up to Fail: Psychological Barriers to Negotiation Success

Senior Associate Dean and Professor John Roberts
Entrepreneurship in Asia

Professor Channing Robertson
Brave New World: Bio-X and You

A. Michael Spence
Philip H. Knight Professor, Emeritus, and Former Dean, Stanford Graduate School of Business, and 2001 Nobel Laureate in Economic Sciences

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For additional information, please contact Laura Moore at moore_laura@gsb.stanford.edu or 650.723.2694
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