Gregory A. Fossedal

THE UNACCOUNTABLE MYSTIQUE OF PAUL VOLCKER

Some call him the second most powerful man in the world—second to none.

He is, by most accounts, "the second most powerful man in Washington," with perhaps the chief dissent coming from those who regard that formulation as an understatement. His press clippings read like the advertisement for a Steven Spielberg film. "The most brilliant politician of our age," says Steve Forbes, younger half of the business magazine dynasty. "Superbureaucrat," echo columnists Evans and Novak, only half-snidely. Congressman Jack Kemp has already worked him into the series of wry denials that presidential candidates, like Kemp, are expected to utter when asked if they are presidential candidates: Questioned about his 1988 intentions by a student journalist, Mr. Kemp said he was shooting "for a position of real power and influence. . . . I want to be chairman of the Federal Reserve."

Politicians and journalists may be suspected of overstatement, but those who harbor any doubt of Paul Volcker's power need only watch the financial markets. Show up on Wall Street on a Thursday afternoon and you will see the frantic trading that follows the Fed's weekly release of "money supply" figures. By 4:00 many New York marketing men and lawyers are already packing up a bit of reading and catching the train to Morristown, Scarsdale, or Greenwich. Trading on the New York stock exchange has already stopped. But the bond markets are still open, and in the great financial houses such as Salomon Brothers and Merrill Lynch, analysts wait by the phone like Carl Lewis straining at the blocks, ready to place their order on a moment's notice. At 4:15, in come the M-numbers. The runners are off.

In the frantic trading that follows, bond prices can move up or down by the interest rate equivalent of roughly half a point. Also open is the Chicago stock market, where on one afternoon in 1982 the Standard and Poors index fell a full 180 points in the minutes after the M-1 money figures were announced. Commodities markets lurch up and down in tandem. Few attempts have been made to aggregate the value of these trading orgies, but a quick check with several economist friends suggests that stock, bond, and commodities prices may rise or fall by $100 billion in a few minutes—all the result of a weekly money supply figure that usually rises or falls less than $5 billion.

It is not that these arcane statistics have any intrinsic significance. The weekly figures will be revised several times over the next few years; often what appeared to be a jump of $2 billion was a fall of $3 billion. All out of a $4 trillion economy.

And yet, the reaction, though annoying to Volcker and the Fed, is in some way correct, because the weekly money supply figures are one of the few indications the market will get about whether the Fed will buy or sell bonds in the coming days. The meetings of the Fed's Open Market Committee, after all, are secret, to be announced weeks later, and then only after another meeting has taken place that may have wiped out the effects of the meeting just announced anyway. Academicians may dispute whether the Fed, in the long term, has the power to "control" various economic variables. In the meantime, however, those traders have to deal with what they see as a central reality: The Fed sets interest rates, and its actions over the coming days can make or break fortunes, indeed, whole banks (Continental Illinois) and nations (Brazil, Argentina, Nigeria).

The frantic traders are simply trying to guess what the Fed will do next. They know that the estimate of past money supply figures is one of a number of "complex factors," as Volcker puts it, that the Fed uses to evaluate whether it has set interest rates too high, too low, or about right. A slight jump in the money figures, though unimportant in itself, might lead the Fed to fear the economy is "overheating." If so, the Fed will raise interest rates. A fall in the money supply could signal that "inflation is still under control" to the Fed's eye. That would allow Volcker to lower interest rates in the coming days. A skim through the financial pages reveals such assessments as "Dow-Jones Industrial average closed down 6.07 . . . on rumors—later denied—that the Fed was to increase its discount rate." Or, "Industrials surge 26.17 in Late Rally on IBM Profit, Expected M-1 drop."

Few would dispute Volcker's raw influence over such events. Beyond that, however, there is little agreement about this complex man and his role as key economic policy-maker through four administrations. To some, Volcker is the devil incarnate, the man, depending on your view, who savaged the re-election prospects of Jimmy Carter in 1979 with his deliberate policy of double-digit interest rates, or who helped smash the Bretton Woods gold standard as a key Nixon Treasury aide. To others, he is a kind of monetary Mother Teresa, the man who first whipped inflation and then ushered in the Reagan prosperity. But to most, Volcker, and indeed the Fed as an institution, are simply confusing, a group of bankers who publish arcane reports about the effects of increasing the efficiency of reporting on lagged reserves, and who thus can be safely ignored. As Walter Mondale put it, and as most politicians and editorial writers seem content to have it, let the experts debate such technical issues as "price rules" and the "money supply." We can all concentrate on the really important economic variables,

Gregory A. Fossedal is an editorial writer for the Wall Street Journal *and co-author of* A Defense that Defends *(Devin-Adair).*

like cutting the deficit and increasing the personal savings rate.

Those who have studied the Federal Reserve even a bit believe that this view is profoundly mistaken. You can observe a lot by watching, as Yogi Berra noticed, and most who watch the Fed regularly conclude that it has more influence over the economy than any other single institution in the country. One cannot afford to ignore it and hope to produce stable prices and growth any more than one can afford to ignore military waste and hope to build support for a strong defense. The actions of Volcker will be critical to the fate of a second Reagan term, even the President's ability to trim the federal deficit.[1]

Broadly speaking, the chairman of the Federal Reserve has three jobs.

First, he is supposed to keep the Fed nonpartisan, above the political fray. One can quibble about how reasonable this objective is. John T. Wooley, who recently conducted a rare study of the Fed for the Brookings Institution, writes: "The notion that such an important body could not be involved in politics is simply a delusion." Even in behaving so as to guard its own independence, the Fed is engaging in a kind of politics. Still, there is a consensus of sorts that the Fed should strive, however imperfectly, to achieve a kind of League of Women Voters status, and the closer it comes, the better.

Second, the chairman of the Fed serves as top regulator of the nation's banks. Along with such institutions as the Federal Deposit Insurance Corporation, his staff audits the balance sheets to make sure that loans and statements reflect their true value. The goal is to protect savers and investors from a return to the rickety, house-of-cards structure that collapsed in the Great Depression.

And third, the chairman manages monetary policy: buying and selling bonds, raising and lowering the federal funds rate, and using other tools in pursuit of the ultimate monetary objective—price stability. In the past, the Fed did this either by targeting the price of gold (roughly, 1944-71) or interest rates (1971-79) or the money supply (1979-82). But today, it is more or less up to the Fed's *ad hoc* discretion, its "feel for things." From the right money policy, it is assumed, will flow low interest rates, steady and high employment, and economic growth, provided there are no world wars, trade wars, or grossly irresponsible fiscal policy.

Has Volcker performed these tasks well? Certainly the Fed has more power today, and in that sense is more "independent" of Congress. But in the same sense, the Fed may be more political than at any time in its history. One example is the debate over the federal deficit, a debate that Volcker regularly engages in, lecturing Congress on the front pages that its failure to raise taxes is ruining the economy. (And when Volcker appears on the hill, characteristically, he is not the ball but the bat, telling the congressmen what to do about taxes, spending, and regulation, rather than answering their questions about what he is doing to interest rates, inflation, and unemployment.)

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A more concrete example came when George Bush tried to press a banking deregulation bill through Congress in 1983. Many bankers opposed the bill because it would have opened them up to greater competition from quasi-banking institutions such as "thrifts." But the key opposition came from Volcker, who feared the proposal would loosen the Fed's regulatory grip on elements of the banking system. "Volcker rolled us," a Bush aide told me. "He went up against George Bush and he won." Later that year, Volcker joined forces with large banks and the Third World to push a Reagan-backed bill to replenish the coffers of the International Monetary Fund with a fresh U.S. contribution of $8 billion. For a time, it appeared that a hybrid coalition of supply-siders and liberals might block the bill until the IMF was forced to stop foisting its well-known austerity schemes on debtor countries as a price for its largesse. At the last minute, the IMF money was attached to a major housing bill supported by the real estate lobby. Aptly dubbed "The Volcker Housing Bill" by the *Wall Street Journal,* the new hybrid passed by a few votes.

Of course many consider the Fed's clout to be benign, particularly the managers of large banks. Oddly enough, though, not even the banks have thrived under Volcker. Indeed, the system came seriously close to a collapse in 1982 and again this year, and the rumblings continue today. The buildup of overextended foreign lending that began in the OPEC years has been continued and expanded. Rather than forcing the banks to "write down" the paper value of loans that are not likely to be paid back, the Fed has winked at the practice and even encouraged increased foreign lending—without the reforms in Third World economic policy that would make the loans repayable.

Indeed, one New Orleans banker reports that Volcker himself phoned to threaten sterner auditing by the Fed's bureaucrats if his bank did not make a series of foreign loans it considered unwise. Similar charges have been made, to Volcker's face and in print, by former Chase Manhattan Chairman George Champion and ex-Reagan aide Paul Craig Roberts. Volcker has never confirmed or denied the allegations.

By last summer, despite the general economic recovery, the share-to-earnings ratio of major banks—a rough proxy for what stock buyers think the banks' loans are really worth—had fallen below five-to-one, and for banks with heavy foreign loan commitments it was three-to-one. By contrast, most industrial firms enjoy earnings ratios of eleven-to-one or more. A 1984 report from Moody's suggested that the American banking system has never been in worse shape. "The banking system is rotten to its core," says award-winning economist Peter Berstein. Mr. Champion "cannot remember a time when the system was in greater danger, thanks to the poor management of Paul Volcker." Perhaps the best overall gauge of banking health, the Merrill Lynch money-center stock average, fell by almost 35 percent over the last year, dipping to below 140 from a one-time high of 210.

That still leaves the Fed's most important objective, stable prices, and the corollary of low interest rates. The chart below compares Mr. Volcker's performance, from 1979 on, with that of previous Fed regimes.*

One could introduce a hundred caveats. One could point to today's federal deficit, which previous Fed chairmen did not have to deal with. But actually, deficits throughout Volcker's term have been only slightly higher than for other Fed chairmen. In fact, Volcker came into office with the federal budget a mere $30 billion in the red and projected to achieve a balance in 1981. The U.S. was actually in the black if you counted in state and local surpluses, as you should. Even today's "Reagan deficits," years off when Paul Volcker took the monetary reins under Jimmy Carter, are small compared to European countries where lower interest rates prevail.

So one could note that past Fed policy gave Volcker a legacy of inflation that took time to conquer. A good point. But then, those past Fed policies did not arrive out of thin air. Mr. Volcker sat on the Federal Reserve Board as head of the New York Fed from 1975 until his appointment as chairman in 1979. He dissented from the Fed's view only twice in those years, urging a puny extra half a point rise in the spring of 1979, with the consumer price index already running above 10 percent.

One might go back even further and bemoan the collapse of international monetary arrangements in 1971—as Volcker did when he took office, pointing to "years of instability and inflation." Yet it was Paul Volcker, along with John Connally and George Shultz, who engineered those events. As Nixon's undersecretary of the Treasury for monetary affairs, Volcker helped implement wage and price controls and the closing of the gold window, negotiated the first and second

*The Volcker Years, 1979-??

Years	Inflation[1]	Short term interest rate[2]	Long term interest rate[3]
1960-70	2.7	4.6	4.9
1970-79	7.9	6.3	7.7
1979-83	8.8	12.1	15.1

Source: President's annual economic report. [1]Average annual change, consumer price index. [2]Average rate, 90-day Treasury bill. [3]Average rate, 20-year bond.

[1]See my article, "The Deficit Reduction Industry," in the May 1984 *American Spectator.*

Nixon devaluations of the dollar, and in 1973 completed the transition to the floating exchange rate "system"—as against the fixed rates worked out by John Keynes at Bretton Woods.

Most modern economic texts regard as the chief achievement of Bretton Woods the creation of such institutions as the IMF. Actually, the key provisions were monetary, and it is in that sense that we speak of the agreement's breakup. Under Bretton Woods, all foreign currencies were linked to the dollar at a fixed rate of exchange, and countries were responsible for maintaining their currency at the agreed level. The dollar, in turn, was linked to gold. It was up to the U.S. to protect the whole system from inflations and deflations by keeping the dollar, as John F. Kennedy put it, "as good as gold." What you had, in effect, was world money. And a boom in trade and growth from 1944 to 1971 seldom seen in world history.

Of course such a system also produced friction. The French, resenting the U.S. role at the center of the system, periodically rebelled. Third World nations saw a colonial conspiracy. U.S. presidential candidates sought to manipulate U.S. monetary policy to promote a well-timed boom or bust just before the vote. These are the natural headaches of producing an international currency, but to Volcker, the banking community, and economists, all this hubris was inexcusable. If only the politicians could be removed from the process and money run at the bankers' discretion, the crises would smooth out. What problems remained would be solved by the magic of the market place: If a country started to inflate or deflate its currency, you simply let it rise or fall against the others; the country would only be hurting itself.

The idea of floating currencies also fit in neatly to the nationalist trade policies of Treasury Secretary John Connally. Connally was in search of a way to improve the U.S. balance of trade, reducing the demand for "cheap Japanese imports," without being overtly protectionist. Volcker, and others fascinated with currency manipulation, provided what they thought was an answer: Cheapen the dollar. By changing the unit of account—the dollar—relative to other currencies, such as the yen, the U.S. could somehow change the terms of trade in its favor.

It should be noted that it was mostly liberals who warned of the dangers of this Nixon policy. Conservatives, on the other hand, found the whole notion strangely appealing. Some of them harbored an unfettered enthusiasm for free markets, failing to remember that a well-managed currency makes free markets possible. Others saw it all as a move toward Milton Friedman's argument for a quantity standard for money. Democrats, however, were suspicious, as Volcker found in a series of heated exchanges on Capitol Hill. "Making the dollar worth less," Robert Byrd argued, "will make it worthless." William Proxmire said of the Volcker trade balance theory, "I would like to believe that there will be some decline in Japanese imports. . . . I hope they'll be buying our automobiles and televisions in Japan, but I doubt it. I sure doubt it." Today, a return to Bretton Woods is regarded as a right-wing idea, and it is Democrats who are hypnotized by trade and budget deficits. But in the Bretton Woods era, the arrangement was seen as a popular check on an otherwise dangerous central bank elite.

When Volcker appears on the hill he is not the ball but the bat, telling the congressmen what to do about taxes, spending, and regulation rather than answering their questions.

If Volcker was not running the Fed in the early 1970s, he was surely supporting it. Asked in 1971 testimony if the Nixon devaluation policy and Fed easy money might not be prompting a world inflation, Volcker said: "I think those fears . . . are greatly overstated." In 1972, as the economy slumped, he predicted a quick turnaround: "We take pride in the record of our leadership. . . . We took the painful measures needed to restore the domestic and international strength of the U.S. economy. . . . Our moves will yield major support to our balance of payments in the course of 1972 and 1973 after the present period of initial, perverse effects ends." When all this proved wrong and a second devaluation, along with continuing price controls, was worked out in 1973, Volcker said the program "will attack directly and effectively the imbalances that have plagued world payments for too long." As late as 1979, Volcker told a group of European bankers that "the extreme instability of exchange rates of recent years" would prove to be, "in retrospect, just a historical episode."

In the event, currency manipulation didn't improve either the U.S. balance of trade or "stabilize things." The Volcker devaluations of 1971 and 1973, in combination with the Fed policy Volcker supported, simply led to a quadrupling of the price of gold, massive expansion of the money supply, and the OPEC inflation of the 1970s. The U.S. trade deficit, now carrying huge oil import burdens, mushroomed.

Oddly enough, the resulting "petrodollar crisis" served to advance the careers of such men as Volcker and George Shultz. After all, someone was now needed to "recycle" the dollars flowing to Saudi Arabia. Someone, it turned out, was the IMF and the World Bank. Bankers promoted a number of changes in the 1970s that strengthened the hand of those institutions in dictating economic policy to debtor nations, and the policies, of course, always hinged on tax increases and currency manipulation. To the casual observer, all these reforms looked like a natural attempt to shore up the instability that floating exchange rates somehow had made worse. The real agenda was neatly summed up by Volcker in a chapter he contributed to a book on "World Monetary Disorder": "The object, quite frankly, is to bring a little more international political clout to the IMF."

The Volcker IMF policy, too, has produced dubious results in the last ten years. Third World economies hover near the brink, requiring regular infusions of cash just to make their (artificially low) interest payments. Naturally, the Fed has emerged as a chief behind-the-scenes negotiator in these rescue deals, tacitly underwriting, for example, a series of IMF and private bank loans to Venezuela. Indeed, as veteran Fed-watcher Max Newton wrote, Volcker, alone among men, has been "involved in virtually every major economic decision since 1969."

Reagan and his supporters must thus ask whether the fate of the economy—and thereby, potentially, their hopes for a majority party—can be entrusted to four more years of Volckernomics. The Fed chairman's record of coexistence with Reaganomics is mixed. In a deal made in the spring of 1981, Volcker agreed to support the Kemp-Roth-Reagan tax cut. As a price, however, he demanded almost total immunity from White House criticism of his handling of monetary policy. The result was a drastic Volcker tightening, based on the erroneous fear that the economy was growing too fast and would immediately spark inflation after the tax cut, which produced the 1981-82 recession. Could Reagan endure another such recession in 1985? Can he pass a flat tax bill, or enterprise zones, or any other economic initiative, with the Fed squeezing down on growth, and its chairman testifying that what the economy really needs is a value-added or "consumption" tax?

The record gives little reason to think the prospect of an economic downswing would trouble Volcker. As economists Paul Craig Roberts, Alan Reynolds, and Warren Brookes have all noted, Reagan is the first President in many years to have faced re-election at the height of a sustained Fed effort to slow down economic growth. The Fed's own minutes from spring 1984 suggest that higher interest rates throughout the summer and fall were a deliberate policy designed to slow growth to a level the Fed arbitrarily regards as "sustainable," about 3 percent. Note: If that rate of growth prevails in Reagan's second term, the federal budget deficit will indeed not shrink and may grow.

Perhaps the Fed chairman's attitude toward Reagan was best summed up by a little-reported incident of a year ago, when the President tried to place a transatlantic call to Volcker, who was traveling in Europe. Reagan's aides were having little luck with Catherine Mallardi, Mr. Volcker's private secretary, who was apparently under orders to screen any calls from the White House. So, in a rare display of hands-on involvement, the Gipper himself took the phone, explaining that he would like the name and number of Mr. Volcker's hotel abroad. Ms. Mallardi firmly told the President that she would not disturb the sleeping Mr. Volcker in Europe; "perhaps tomorrow." Chastened, Mr. Reagan agreed to try for an audience in the morning.

The one thing Volcker is certain to do in Reagan's second term is to serve the interests of Paul Volcker. Those interests do not necessarily coincide with the President's. Secrecy, freedom of maneuver, and *ad hoc* discretion enhance Volcker's power; concrete policies, statements, and adherence to the White House will diminish it. A successful Reagan will set his own agenda. A crippled Reagan would have to cut deals for Volcker's support. And let us not forget that most basic human foible, one to which a man like Volcker is particularly prone: envy. Volcker can hardly expect credit for whipping inflation, narrowing the deficits, and ushering in an age of prosperity if all the attention is focused on Ronald Reagan.

The White House seems to be of

varied opinions on the subject of a Volcker strategy, none very promising. One view is that there is no need to control the Fed. Volcker is doing a fine job, can be trusted, and is completely under White House control. No supply-sider, monetarist, or Keynesian true to his model would say this after the last five years, but the argument survives. It is bound to fade, absent a Volcker loosening in the coming months.

Another school concedes that Volcker may be a grave threat, but says there is nothing that can be done to hold him in check. "The markets and the bankers wouldn't stand for it" if Volcker were removed, one White House aide argues. And short of removal, this school argues, there is little you can do to rein in a Fed chairman.

Actually, if the "market" is any guide, the replacement of Volcker with a suitably knowledgeable man—Preston Martin, Lew Lehrman—might prompt a Wall Street rally. The market reacted favorably throughout 1983 to news leaks suggesting Volcker would not be reappointed. My own guess is that the news of Volcker's replacement would at worst produce a drop on the market one day of 15 points, to be met by a rise the next day of 15 points. It might prompt a major rally. In any case, the reaction of the stock market over three days is no datum on which to base four years of economic policy. As for the notion that there are no levers short of firing Volcker, let me suggest at least four:

First, put a spotlight on the Fed's operations. One bill now in Congress would require immediate and complete release of the Fed's minutes, including transcripts. This would at least clarify what the Fed is up to. There are solid economic grounds for doing so: Markets will function more smoothly if they do not have to rely on tea leaves and $200,000 a year Fed-watcher consultants for information about what the bank plans. And there are ample political grounds for making the nation's most powerful economic institution more accountable.

Second, have a clearly defined monetary policy—the best way to promote accountability. Jack Kemp has a bill to base that policy on the gold standard. Others would prefer a quantity rule (monetarism) or interest rate targeting, and have their own bills in the hopper. Almost all agree, however, that Congress, which created the Fed, can tell the Fed how to conduct policy, and that the economy would be better off with even a bad policy than with none at all.

Third, change the Fed chairman's term to coincide with the President's. At present, a President must wait two-and-one-half years to name his own man at the bank. A number of bills would alter the term to allow a President to appoint the chairman within a few months of his own inauguration. Volcker himself supports the idea, and has offered to step down if such a bill were passed. Reagan should take that offer up.

Fourth, even without taking any of the above steps, the White House could substantially influence Fed policy simply by telling the Fed what it wants. Unfortunately, when Reagan tried this in his first term, his signals were either hopelessly vague or, worse, contradictory. Sometimes Reagan asked for a Fed policy to "continue growth at a sustainable, non-inflationary level." Oh really? And how do you do that?

There are, however, strong reasons to think the President will adopt one or all of these strategies. For one, we have the rising prestige, within the White House and even in *Time* and *Newsweek,* of the supply-side model, which has after all predicted virtually every turning point over the last six years. One only hopes that Mr. Reagan will set himself up for a regular briefing from a Reynolds, Roberts, or Jude Wanniski about the cause of high interest rates or the nuts and bolts of the Fed. He has apparently been doing so in sparse measure through such aides as Bruce Chapman and Edwin Meese, whose understanding of the monetary debate has allowed them to fill a gaping power vacuum on the Reagan team.

Then, too, there are politics. The battle for Reagan's succession is already underway. Jack Kemp seems to be leading a growing consensus in Congress, academia, and the popular press that the Fed must once again be reined in. Though they disagree violently about what Fed policy should be, liberals and conservatives, monetarists and supply-siders alike seem to agree that something on the order of the steps outlined above must be done. Kemp is hardly likely to stop pushing the issue he has championed now that he is unofficially running for President.

One certainty: No President or presidential candidate can safely afford to ignore the Fed. Richard Nixon told me not long ago that one of his "biggest mistakes" was not learning about the operations of the Fed, an ignorance that led him to lose in 1960 and to buy the mistaken arguments of Volcker and Company in the 1970s. George Bush, Howard Baker, and Robert Dole, take note. □

John Train

AMERICA THE BEAUTIFUL

The key to our defenses may lie just beyond the horizon.

Imagine a city of 5,000 whose inhabitants dwell far below street level and rarely come up to daylight. Why bother? After all, there's nothing you can do when you get to the surface except stand in a confined area, called "Vulture's Row," where you can look around but only walk a few dozen steps.

Virtually cut off from the rest of the world—mail comes and goes at intervals, but there is no telephone—the city makes its own rules. Indeed, in organization it resembles Plato's ideal republic. There are the leaders (Plato's "guardians") and the led. Poverty has been vanquished. All know their place and work pretty much 'round the clock. Fourteen-hour days aren't unusual. As republics go, it's certainly a lot closer to Sparta than Athens: there's little room for art or philosophy, and a lot of emphasis on the martial virtues.

There are some odd features about this city. For instance, every now and again you're conscious of a tiny earthquake: The whole city shudders slightly, and you hear a gasping sound, as though Old Faithful had spouted up above. Then, there's the quantity of electrical wiring. It's almost unbelievable. In some areas if you look up you can see running along the ceiling hundreds and hundreds of conduits, large and small, from the equivalent of fingers to bundles like arms or even legs. If you pulled them all together they might be as thick as a man's torso, or even the body of a horse.

I recently came back from the city in question. It is stationed just off the Persian Gulf, and its name is the USS *America,* one of the fourteen aircraft carriers that form the core of our surface navy, and probably the one that will move into action if the Saudis or their neighbors appeal for air cover against Iranian attack on their territory or their shipping. Much careful general staff calculation goes on in Teheran, Baghdad, Riyadh, and elsewhere about what the *America* represents, with its accompanying ships and their potential reinforcements. If ever fully committed, the *America* by itself could probably destroy the Iranian air force *in toto* and demolish all the significant targets in the country. That, in fact, is its business.

Carrying out that business requires a sophistication and complexity far beyond any normal ship. In fact, the

John Train is author of The Money Masters, Remarkable Names, *and other books, and is a columnist in* Le Matin *(Paris),* Harvard Magazine, *and* Investors Chronicle *(London).*