POLICY REPORT

SPECIAL CONFERENCE ISSUE

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World Debt and Monetary Order

Some 300 participants listen to the conference's opening session.

For a time it seemed as though the international debt crisis might have eased. Then there was a "second wave" of the crisis and now, it seems, a third wave. Mexico and Brazil are finding serious problems in their ability to meet the terms of their agreements. New governments in Venezuela and Argentina are resisting the austerity measures being demanded as the price for their predecessors' excesses. With the debt situation apparently becoming critical again, the Cato Institute invited some two dozen scholars to discuss origins and solutions for the debt crisis at its second annual monetary conference. This issue of ***Policy Report*** *contains excerpts from several presentations given at that conference. The complete papers will appear in the* ***Cato Journal****, available for $5.00 from the Cato Institute.*

The Roots of the Crisis

by James B. Burnham

Let me start with a highly condensed summary of the origins of the current international debt situation. In the 1970s, responding to a variety of economic, political, and social pressures, major governments around the world—including the United States—countenanced or encouraged excessively rapid acceleration in their national money supplies. The path of least resistance to a variety of adjustment problems, of which OPEC oil price increases were only the most visible, was seen to be in more rapid growth of the money supply and the resulting inflation. Simply put, if one is to have stable prices on average, for every price that goes up, some other price has to go down. And most people who are producing and selling are not terribly keen on falling prices for their own products or services. In the final analysis, inflation is the monetary expression of a political process.

The tendency to point the finger at OPEC and oil price rises as the source of the inflationary upsurge of the 1970s and the associated recycling of "petrodollars" and buildup of LDC debt is understandable. But it ignores a crucial link in what actually happened. It was necessary for the major central banks, above all that of the United States, to ratify the potential inflationary pressures which were being set in motion by higher oil prices. The OPEC oil price increases were neither a necessary nor sufficient condition for the inflation and debt buildup of the 1970s.

Thus, as a result of the interaction of politics and monetary policy, price increases in the 1970s accelerated with occasional periods of weakness corresponding to business recessions. An inevitable corollary of this process was an equally rapid expansion in credit of all forms, but most obviously bank credit. Indeed, the price of credit (interest rates) increased less than the average price level, resulting in negative real interest rates—and, not surprisingly, further stimulating the demand for borrowing.

In this kind of environment, with expectations of double digit inflation becoming more and more deeply embedded, those who failed to increase their borrowing were considered to be the slow learners. Those who made the front covers of *Farm Journal*, *Fortune*, or *Euromoney* were the big borrowers, each in their own league, with debt coverage ratios that would have made a 1960s financial adviser or analyst cringe.

What of the role of the commercial banks in this process? To what extent are they responsible for the situation in which they (and their borrowers) find themselves? I view them more as passive actors than as conscious agents recklessly putting at risk shareholder equity or their depositors' funds. The necessary corollary to excessively rapid expansion of the money supply was excessively rapid extension of bank (and other) credit. With a banking system based on fractional legal reserves, and an underlying entrepreneurial spirit on the part of financial market operators, it was inevitable that excessively rapid creation of bank reserves would lead to a corresponding increase in lending ac-

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James B. Burnham is U.S. Executive Director of the World Bank.

EDITORIAL

Spending is Still Going Up

The consensus in Washington is that the deficit must be reduced, and that since spending—at least domestic spending—has been pared to the bone, tax increases are required. After several years in Washington, we are still amazed at just how far wrong the conventional wisdom can be. As usual, both conservatives and liberals have managed to miss the realities of the budget debate.

Of course, the newfound concern of liberals over the deficit is almost laughable. Does anyone seriously believe that Walter Mondale worries about the growth of deficit spending? The tragedy is the spectacle of conservatives insisting that deficits aren't so bad after all. The fact is that deficits do matter. They must be financed either by monetization—money creation—which creates inflation, or by borrowing.

But the deficit is not the real issue. The real economic problem is the size of government spending, the best measure of government depredation of the private economy. And contrary to the conventional wisdom, President Reagan's 1985 budget is not austere. Spending has not been cut to the bone; in fact, it is higher than ever before. The president proposes to spend $925.5 billion in fiscal 1985, up from an estimated $854 billion in 1984. If we look at authorizations—money authorized in this budget to be spent in 1985 and subsequent years—President Reagan has just submitted the nation's first trillion-dollar budget. One would have thought that that milestone might have been worth a few headlines.

This budget is almost $300 billion higher than President Carter's last budget. Spending is continuing to rise at some 4 percent a year in inflation-adjusted dollars, about the rate of the Carter years and hardly the sign of a Reagan Revolution.

Tax revenues have not been slashed either. Federal revenues averaged 19 percent of GNP during the 1970s. The administration estimates that they will average 18.8 percent for 1983-88 *without* any of the tax increases currently under discussion. According to the Institute for Research on the Economics of Taxation, "Tax receipts would have to rise more than 20 percent above their 1970-1980 average to match the outlays projected for the 1983-88 period." The deficit is a result of overspending, not undertaxing.

Many people, of course, are proposing tax increases to reduce the deficit. The Democrats, normally champions of higher taxes, are content to let such conservatives as Sen. Robert Dole and George Will take the lead this time. Make no mistake about it: Tax increases would discourage saving and investment, and have a serious impact on business expansion and economic growth. Many of the proposed tax increases would be surprisingly expensive. In any case, as Milton Friedman says, "if increasing taxes could eliminate the deficit, we would have eliminated the deficit long ago. Taxes have been going up for 30 years."

If we reject tax increases—both for reasons of individual freedom and for economic growth—we must look for ways to cut spending in this allegedly austere budget. Here, both liberals and conservatives have helped to obfuscate the issue. Liberals complain about the meat-ax cuts in domestic spending, decrying President Reagan's "cruelty" and "lack of compassion." Yet nondefense spending is scheduled to rise from $616 billion in 1984 to $653 billion in 1985. (It was $344 billion in 1978.) Payments to individuals will increase from $413 billion to $441 billion.

Conservatives, on the other hand, complain that defense spending isn't really increasing. Columnist M. Stanton Evans writes, "Defense spending as a percent of the budget has decreased dramatically, but the Reagan program has corrected this only marginally." But this is because the overall budget has risen so rapidly. By this logic, if Congress doubled Social Security payments, defense spending would fall as a percentage of the budget—and we would have to drastically increase military spending or be "weaker."

The fact is, both domestic and military spending are going up, and we need cuts in both. In the military area, there are many unnecessary bases kept in the budget for congressional pork-barrel reasons. There are scandals in the procurement process. There are weapons unwanted by the Pentagon but produced to satisfy powerful members of Congress. But more fundamentally, it is time for Americans to take a good hard look at why we spend $129 billion a year—$696 for the average worker—to defend Western Europe, and $47 billion—$253 per family—on Japan and East Asia. These countries can surely afford to begin paying for their own defenses.

In the domestic area there are myriad places to cut. The budget contains hundreds or thousands of subsidies to special interests. As in every February, the release of this year's budget sent hundreds of interest groups scurrying to look at the numbers for their programs. Their comments ranged from outrage to ingratitude ("This budget increase is a sop"). We could start by eliminating all such special-interest subsidies.

There are larger programs, too: $10.8 billion for farm price supports, $700 million for Amtrak, $400 million for maritime subsidies, $4.6 billion for revenue sharing, $2.3 billion for the strategic petroleum reserve, $16 billion for foreign aid, and so on ad infinitum. Surely Americans could survive—perhaps even prosper—without some of these programs.

Besides the immediate benefits of making these cuts, they would have an important secondary effect: By reducing the government's extraction of resources from the productive private sector, and lessening the likelihood of tax increases, they would help to revitalize the economy and make reductions in programs like unemployment compensation easier.

The budget is still going up, under the direction of the biggest-spending president and Congress in history. Spending reductions are not impossible or even difficult; they just require political courage, a commodity in critically short supply in Washington. ■

World Debt (Cont. from p. 1)

tivity, at home as well as abroad. The resulting acceleration in inflationary pressures altered expectations of future cash flows and views about appropriate debt/equity ratios and the structure of any given level of indebtedness. Indeed, when all the returns are in, I suspect we will find far more bank losses arising out of overly optimistic domestic energy lending than from loans to developing countries.

The criticism that commercial bankers are receiving today, as a group, overlooks the fact that they were responding as financial intermediaries are supposed to in an expansionary monetary policy environment. Many of the charges being made today are no more than echoes of the extensive congressional hearings in the early 1930s, which delved into the role of the investment bankers and their flotation of developing country bonds on the U.S. market.

Three Alternatives

by Allan H. Meltzer

One of the big errors that people have when they approach the debt problem is to look at the problem in terms of the causes of the problem as being related to the high interest rates in the United States or the oil shock. (We read a lot about how the oil shock caused this problem for particular countries.) But, of course, on more than superficial examination, that doesn't stand up. The problem arises in countries which are oil exporters like Mexico, or Nigeria, or Venezuela, and countries that are oil importers like Brazil, and countries that are neither oil exporters nor oil importers like Argentina. So there really is no unique relationship between whether a country is an importer or exporter of oil and whether it has a problem.

In Brazil, Mexico and Argentina, what we observe is the interaction between financial distress and public policy. It is the public policies of those countries, whether they are oil importers or oil exporters, that have produced much of the problem here. And the problem is that the allocation of resources and investment in each of those countries has been dominantly controlled by the government, operating to a greater or lesser degree under the rules or procedures suggested by the Economic Commission for Latin America. That Commission told these countries to sacrifice efficiency by having the allocation of resources placed in the hands of the government rather than in the hands of the market, and to substitute domestic production, whether or not it would meet a market test, for imports coming from abroad. The public allocation of resources, of course, built in a large amount of inefficiency—the building of the Itaipu Dam between Paraguay and Brazil, the building of roads to cross the Amazon are familiar examples. One need only visit the Mexican economy briefly to see visible signs of the inefficiency of the public sector there. These countries also saw the building of a large and often inefficient industrial base through the mechanism of import substitution.

When the problems came, it was those countries which had relied upon this inefficient mechanism that suffered the largest amount of distortions. They continued to borrow over those distortions because they were given government-guaranteed loans that allowed their debts to go up by something in the neighborhood of 30 to 40 percent, and thereby, produced the present period of financial distress. There were other countries which continued to grow through this period. Like the famous gang of four in Asia—Taiwan, South Korea, Hong Kong, and Singapore—which didn't practice those kind of policies, didn't leave the principal allocation of resources to government, and therefore didn't suffer nearly as much when the world conditions changed from continuing inflation to disinflation.

If you believe that there is now a debt problem, there are really three kinds of solutions. One is to muddle along from one period of financial distress to the next, as we have been doing over the past several years, and as we will continue to do under this mixed set of national and international policies. That way preserves uncertainty and promotes distress by continuing to have a series of crises that deter any kind of solution to the longer-term problems.

The second way, the way that seems most probable, given the proclivities of

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Allan H. Meltzer is John M. Olin Professor of Political Economy and Public Policy at Carnegie-Mellon University.

In This Issue

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David Boaz . . . . Editor
Tyler Cowen, Daniel Klein, Tom G. Palmer, R. Richard Geddes . . . Contributors

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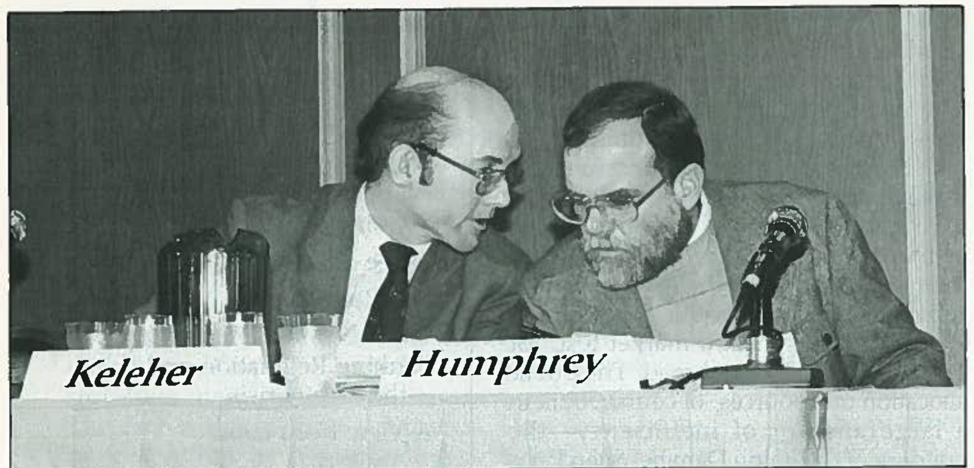
World Debt (Cont. from p. 3)



Robert Keleher of the Atlanta Federal Reserve Bank talks with Thomas Humphrey of the Richmond Fed about their paper.

the international organizations, is to move to a system of forced lending. That is a system under which governments around the world would get additional lending to continue to operate their economies. Banks would in effect be forced to keep extending the maturity of their debt. One sees signs of that already in the recent negotiations with Poland and also in what the Argentines have been asking for.

The third, and I believe the more appropriate, solution is to recognize that some mistakes have been made. These mistakes were not due to market failure; they were due to the fact that countries pursued inefficient policies, and that lenders took seriously the guarantees of the governments and the programs of the International Monetary Fund. The solution to that problem, I believe, is to revalue the debt at market prices. We know something about what that would do, because there already exist Mexican loans outstanding, sold every day on the financial markets in London. The last time I looked, 16 percent bonds were selling somewhere in the range of 70 to 80. So we write down the value of the debts and write off those losses. We exchange at least a portion of the debt for equity public-sector corporations which will be marketable. In effect, we treat the debt of these sovereign governments just as if it were a commercial enterprise that had failed: converting a debt claim by the banks into an equity claim, which some of us think should have been the principal means of financing in the first place, and apply this traditional banking procedure to reduce the volume of debt outstanding.

The Role of U.S. Macroeconomic Policy

by Michael Mussa

The seeds of the current debt crisis were sown in the middle and late 1970s. The external debts of non-OPEC developing countries grew more rapidly than their national incomes after 1973, but the ratio of debt service to export earnings grew only gradually until the alarming increases in 1981 and 1982. In assessing the role of U.S. economic policy in the development of the international debt crisis, therefore, it is useful to consider separately the period from 1973 to 1980 and the period since 1980.

The four-fold increase in the price of crude oil that occurred in late 1973 and early 1974 was widely believed to be an important factor contributing to the world recession of 1974-75. In the Keynesian framework of macroeconomic analysis that dominated official thinking and policy making at that time, the oil price increase was seen as contributing to the recession because the OPEC countries were running huge payments surpluses which represented substantial increases in world savings (at a given level of world income). If not offset by a corresponding increase in spending somewhere else in the world, then (the argument concluded) there would be a reduction in world aggregate demand and in world output. The policy prescription, therefore, was for the governments of the major industrial nations, especially the United States, to run budget deficits to offset the OPEC surplus. In addition, the world financial system was called upon to assist in recycling the OPEC surplus from the OPEC countries that wished to save to countries that wished to borrow and spend. Given this policy objective, governments and regulatory authorities in the United States and other industrial countries generally looked with favor on developments in the international banking system that facilitated increased borrowing by developing countries. Concern was occasionally expressed about excessive borrowing by one or two developing countries, but lending by the international banking system to most developing countries was not discouraged, controlled, or even monitored. Indeed, I recall that at a conference I attended on the subject in 1975, one speaker commented that the problem was not that countries would borrow too much from the international banking system, but rather that there was no country to serve as "the borrower of last resort."

The third mechanism through which U.S. economic policy contributed to the growth of borrowing by developing countries in the 1970s was by assisting in maintaining a high world price of crude oil. The overall effect of the energy policies adopted by the U.S. government between 1974 and 1980 was to discourage domestic production of oil and other energy sources by keeping prices to producers artificially low, to encourage domestic consumption by keeping prices of energy to consumers artificially low, and to encourage oil imports through the allocation scheme for low-priced domestic crude oil. All of these effects contributed to a higher world demand for OPEC oil and thus to a higher world price of oil. Between 1976 and 1979, the declining foreign exchange value of the U.S. dollar reduced the price of OPEC oil (which was priced in U.S. dollars) for countries whose currencies appreciated against the U.S. dollar. This decline in oil prices for other countries, however, stimulated their demand for oil during this period and made the world oil market so tight by 1979 that the supply disruptions associated with the Iranian revolution could not be absorbed without another massive increase in the world oil price.

The high world price of oil contributed to the growth of borrowing by developing countries in different ways for oil importers like Brazil than for oil exporters like Mexico. For oil importers, the increase in the world oil price in 1973 and again in 1979 meant a substantial increase in import costs. This increase in import costs could be absorbed either by reducing other imports and increasing exports or by increased borrowing. With real interest rates very low, especially for U.S. dollar denominated loans, many oil importers decided to borrow to finance at least part of the increased cost of oil imports. For oil exporters, higher world oil prices meant increased export revenues. For some of these exporters like Kuwait and Saudi Arabia, increased revenues were so large that they became substantial net lenders. Other oil exporters with greater domestic absorptive capacities borrowed on the expectation of future oil revenues to finance ambitious development programs whose costs exceeded current revenues from net exports. The outstanding example of a country that pursued such a program is Mexico, which accumulated the second largest external debt of any developing country by 1980.

In summary, by the end of the decade of the 1970s, the external debt of oil importing countries and of some important oil exporters had grown substantially relative to the national incomes of these countries, but debt service requirements had risen only modestly relative to export earnings. Much of the debt to these countries was denominated in U.S. dollars and was owed to the international banking system. The growth of such debt was encouraged by policies of the United States and other industrial countries that facilitated the development of the international banking system as a mechanism for recycling OPEC surpluses. It was also encouraged by the low level of real interest rates on U.S. dollar denominated loans and by the declining foreign exchange value of the U.S. dollar, both of which were at least partly the consequence of U.S. monetary policy. U.S. energy policies which affected the world price of oil also contributed to the growth of external debt of oil importing developing countries and some oil exporters.

Michael Mussa is William H. Abbott Professor of International Business at the University of Chicago.

Jan Tumlir, research director of the General Agreement on Tariffs and Trade, talks with Karl Brunner of the University of Rochester.

Banking Regulation and the Debt Crisis

by A. James Meigs

There is an inescapable dilemma in attempting to avert risk through regulation. Regulation exacts a price; regulation reduces resilience in the system. Preoccupation with attempting to anticipate and to avert potential dangers uses up resources that might be better used in responding to actual dangers when they materialize. It also deprives people of experience in coping with failure.

The costs of regulation in terms of lost resilience can clearly be seen in the experience of U.S. financial institutions and markets under the regulations adopted in reaction to the Depression. During the 1960s and 1970s it became increasingly evident that these Depression-inspired regulations made it difficult for U.S. financial institutions to cope with a completely different and unforeseen set of problems. The new problems for portfolio management were raised by high, and highly variable, interest rates, inflation, and a series of recessions. Banks and other institutions innovated feverishly to find ways to survive under the rate regulations that were originally supposed to protect them from risk.

U.S. banks found that the prohibition of payment of interest on demand deposits, Regulation Q ceilings on time deposits, and reserve requirements placed them at a disadvantage in competing with banks of other countries. Even more important, when interest rates rose, U.S. banks found it difficult to raise funds for their domestic loans and investments. They learned in the mid-1960s to go overseas to tap the new Eurodollar market for funds, where rates were not regulated.

According to the Comptroller of the Currency, there were three national banks with foreign branches at the end of 1960. These three banks' 85 branches reported total assets of $1.6 billion. By the end of 1970, 59 national banks were operating 497 foreign branches with total assets of $39.9 billion. The high

A. James Meigs is senior vice-president and chief economist of First Interstate Bank of California.

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concentration of new offices in London and Nassau suggests that the 1960s outmigration of U.S. banks was largely to gain access to Eurodollars, although it was also possible to raise Eurodollars through correspondents.

Much of the movement of U.S. banks abroad probably would have occurred eventually in any case, but domestic regulation of U.S. financial institutions and markets undoubtedly accelerated it. It is interesting to note that if regulated financial markets are supposed to be less risky than unregulated ones, the regulations themselves induced banks in this case to shift some of their operations into the presumably riskier markets.

New regulatory powers conferred on national governments or international agencies are not always used solely for their declared objectives. Governments come and go; their decisions are subject to political pressures that are difficult for financial managers to predict. Therefore, we should not assume that increasing regulation in international financial markets would reduce risk and uncertainty there. It would instead bring some arbitrary powers into the picture who from time to time could change the rules facing portfolio managers, and thus increase risks.

Additional regulation would also, if the U.S. experience is any guide, reduce resilience in the international financial system by reducing the freedom of managers to adjust to unexpected changes in market conditions. Regulators tend to be slow and deliberate in adjusting their policies to changing conditions. U.S. banks and other financial institutions were fortunate in being able to use international markets for relief when domestic regulations were not adjusted to changing economic conditions in the 1960s and 1970s.

The deregulation movement made little headway against bureaucratic inertia in the United States until the Congress was confronted with the prospect of disaster in savings institutions, unless deposit-rate controls were relaxed and unless institutions were granted broader lending and funding powers. People in government agencies, like anyone else, are extremely reluctant to give up any powers they may have. Furthermore, if the original purposes for which powers were conferred decline in importance, government agencies have proved to be more likely to find new uses for their authority than to give any of it up.

As we consider various proposals for coping with the international debt problem, we should be aware of two potential hazards in their regulatory aspects. The first is the thickening of the supervisory blanket implied by organization of the many cooperative organizations to coordinate supervisory activities and to develop uniform standards that were discussed above. The other is the coercive element in some of the plans for remedying the debt problem. Banks are faced with the prospect of having to accept the terms of negotiations conducted for them by

A. James Meigs

others whether they like them or not. Both of these potential hazards boil down to reductions in the resilience of the financial system—its ability to bounce back—at a time when we are going to need all the resilience we can muster.

With regard to the first potential hazard, supervision is meant to be helpful to banks and other financial institutions. It should be helpful if one believes supervisors have superior foresight and superior information. That is a highly debatable proposition. Furthermore, even when supervision is innocuous, in the sense of interfering little with management discretion in financial institutions, it still absorbs management time and resources that could otherwise be used for innovating and producing financial services. The reporting requirements of supervisory agencies become more burdensome each year. In responding to the international debt problem with new regulations, governments could make mistakes comparable to those U.S. legislators made in responding to the Great Depression.

The coercive elements in some of the proposals for coping with the debt problem would have serious consequences. Suppose for example, a new agency were to be established to convert outstanding bank debts of problem borrowers into new instruments with significantly different terms than those on the original debts, and the banks were to have no say in negotiating the new terms. That would be a direct intervention influencing portfolio management decisions. It would impose a direct cost on each bank involved. But more important would be the damage done to the institutions of property rights and enforcement of contracts that underlie financial markets.

Financial markets are built on complex bundles of property rights and contracts. The greatest service governments can perform for the financial system is to uphold those property rights, by enforcing contracts, and acting as an arbiter in case of disputes. Setting aside any of these rights, even in the interest of dealing with what is viewed as a great international emergency, should not be undertaken lightly. It would increase risks and thus would reduce the international and domestic private capital flows that are essential to future growth and prosperity of the world economy.

Governments have no monopoly on foresight or information bearing on private financial decisions. But they do have a monopoly on the tools of monetary and fiscal policy. If they would turn their attention to using those tools to stabilize the world monetary and economic environment they would contribute far more to resolving the debt problem than if they try to improve the performance of the financial system through regulation.

Additional regulation would not contribute to a solution. It would merely reduce resilience in the financial system, as did the regulations imposed after the Depression. And it would inhibit the ability and willingness of banks and other financial institutions to do their part in restoring the health of the world financial system.

A View from Latin America

by Manuel F. Ayau

The views that prevail in decision-making circles in the creditor nations are not a cause for optimism for those of us in the poor countries who believe that only through a free market can we produce the necessary wealth to pay our debts, while simultaneously raising our quality of life.

The discussion of the solution to the problem in the debtor nations offers even less cause for optimism. At the meeting in Bogota, Colombia, of the Federation of Latin American Banks (FELABAN), which included delegates from sixteen countries and six hundred banks, the most important Latin American bankers warned that to apply extreme austerity to service the exorbitant debt of the region would cause desperation, revolt and catastrophe.

The meeting contained all the usual remarks about oil price increases, deterioration of the terms of trade, high interest rates, and the world recession as the culprits. Not much was said about the failures of the domestic policies of the debtor countries which have made our economies so vulnerable, so inefficient, so inflexible, and so wasteful. The final declaration of the FELABAN, abundant with deterministic lamentations, is truly a naive document.

The signatories recognized that the debt, as it is now structured, is unpayable, and that the past year's experience shows that the possibility of payment is becoming even more remote. They, of course, recognize that the service of the debts must be adjusted to the debtor's ability to generate foreign exchange, and they express the hope that exports increase, and suggest that imports be restricted to essentials. They offer not one word about internal policies to achieve those aspirations, only that the creditor nations should lower import barriers.

Throughout the report, the attitude is that the burden of the solution lies with the creditors: they must be flexible, softer, fairer, patient. One gets the feeling that our debtor-problem countries are victims of too much credit and of unfortunate acts of God, of impersonal forces beyond anyone's control, totally oblivious to the fact that our problems are the predictable results of our own prevailing economic policies.

Their imaginative solution is renegotiations and more credit in order to keep the debtors alive in the hope that they, someday, somehow, may pay their debts. The naiveté goes to the length of suggesting that an attempt be made to convert external debts into equity capital: When considering that most of the debts belong to uneconomical state-owned enterprises (SOEs), the suggestion is ludicrous.

Ironically, the utter failures of our interventionist economies are blamed on the market, on capitalism. The fact is that, after the economic rule of "free enterpriser" Mr. Martínez de Hoz, Argentina was about as free market as Yugoslavia; the fact is that the three basic resources in the Chilean experiment, labor, credit, and foreign exchange, were not free. But these facts do not alter the perception that it was the market economy that failed.

We are a continent wealthy in land, climate and natural resources. Paradoxically, the wealthiest countries (Mexico, Venezuela, Brazil, Argentina) are the ones with the biggest problems. Obviously it is we who are doing something wrong, and not a case where something wrong is being done to us from outside.

The theory that the market does not work and thus we must practice interventionism is belied by the fact that it is the underground economy, or black markets, which are keeping our countries alive, disproving the slogan that "the free market works in theory, but not in practice." It does work in practice but not in *official* theory! We must learn that in order to generate foreign exchange, we must free foreign exchange and lower import and export duties.

In my country, Guatemala, the ridiculous case of free travel exemplifies the counter-productiveness of an overvalued currency: thousands of people who never dreamed of visiting their many relatives who emigrated to the U.S. in the past, now do so at no cost to themselves. They first purchase, at the official rate, the allotted amount of dollars with borrowed local currency, which they pay back immediately after selling on the black market part of the dollars purchased. What they do not sell is sufficient to buy a plane ticket and have some spending money left for their trip.

International (mainly U.S.) financial aid has permitted and encouraged the nationalization of our economies. In general, the bigger the role of the state-owned enterprises (SOEs) the bigger the debt problem, because these enterprises own the larger portion of the debts. SOEs were originally considered good debtors because they enjoyed the unlimited guarantee of the governments, so indirectly they have the coercive power to tax.

I have not seen any studies relating the debt of the SOEs to the total debt, but, for instance, in Mexico the government owns about 1,000 enterprises, including some discotheques! Fifty-eight percent of the public-sector foreign debt is owned by four SOEs (PEMEX, FERROC, CONASUPO and CFE). In Brazil, as of 1981, one-sixth of the country's supermarkets were state owned. In El Salvador, the government banks and finance companies held more than 40 percent of the credit portfolio in the country, but at the suggestion of the U.S. State Department they confiscated 100 percent of the banking system. This is the type of ruinous policies that sometimes come with aid.

Of course, all governments worthy of their underdeveloped credentials are in the business of land, ocean and air transportation, chemicals, power, communications, and subsidized theaters for the cultured elite.

But it is not only the accounting losses of the SOEs themselves that must concern us. The greatest damage is because almost invariably, SOEs produce at higher than competitive prices. Thus they make every one of the users of their services or products less competitive. *And since the activities of the SOEs encompass such vast and basic spheres, they make the whole economy less competitive.*

(Cont. on p. 8)

Manuel F. Ayau is president of Universidad Francisco Marroquin in Guatemala.

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This is the unavoidable result of having placed large amounts of soft credit resources throughout the history of the aid programs at the disposal of statist bureaucrats. Had this boon not been available to bureaucrats, our debts would be minimal and our capacity to pay more than satisfactory, because the enterprises would have been built with risk capital and without the coercive powers to impose the higher-than-market prices that reduce our capacity to pay.

In Latin America, socialism and socialists are already more and more in disfavor. The climate is not as hostile towards the market as it was. There already exist many free-market advocates throughout the region. Many have come to conclude that P.T. Bauer was right all along regarding the impoverishing effects of foreign aid.

It is propitious to convert an impending disaster into a great opportunity. And this could well occur, provided, of course, that for humanitarian reasons official foreign financial assistance and subsidized bailouts are brought to an end, so that the interventionists lose their financial support, and we have no choice but to get down to the business of wealth production through the market system.

One final word regarding the "social cost" of a radical change in policies. First, we must not underestimate the resiliency of people; Latin America, especially, is constantly undergoing violent changes of one kind or another. Many policies may have to be phased out gradually. Others, such as the freeing of exchange rates, must be done overnight. More important than where we are is where we are going.

And there is little question that the "social cost of change" is much lower than "the social cost of not changing."

Protectionism and Coordination

by Roland Vaubel

In the 1930s, just as in the 1970s and '80s, high unemployment strengthened protectionist sentiment. There seems to be general agreement now that mounting U.S. tariffs and the retaliation in Europe and elsewhere aggravated the decline of world trade and economic activity. Probably the most dramatic step was the imposition of the Smoot-Hawley Tariff in June 1930 which raised duties very substantially, notably those on agriculture imports. U.S. protectionism was a major cause of foreign defaults not only because it reduced the exports of the debtor countries but also because, by aggravating the decline in their terms of trade, it increased the opportunity cost of remaining solvent and thus the incentive to default. There is an important lesson to be learned here. However, for rather closed economies like the U.S., the increase in trade barriers cannot have been a major cause of the disaster.

Congressional staffer Morris Goldman listens as Roland Vaubel addresses conference.

Those who believe that the Great Depression cannot be explained without reference to the changes in international trade and capital flows that accompanied it, see the main lesson in a need for closer international coordination. Are these the lessons we have to draw for the 1980s?

The Great Depression did not arise because national monetary authorities ignored their responsibilty for the rest of the world, but because they acted against their own country's interest. Of course, U.S. monetary policy also affected the rest of the world, but this was not an externality or "public bad" in the welfare-theoretic (Pareto-relevant) sense of the word. It was simply interdependence through the market. Individual supply decisions in the world market do not have to be coordinated through negotiations merely because they also affect others. In this respect, there is no difference between the supply of money by the Fed and the supply of automobiles by General Motors. It is the market which acts as a mechanism of coordination. *Interdependence through the market is not a valid justification for non-market coordination.* Nor is there a valid game-theoretic case for monetary policy coordination, when politicians cannot be relied upon to pursue the national interest.

The problem in the 1930s was not that there was too little international monetary collusion but that there was too much of it. The problem was that the gold-exchange standard had created a price cartel of money suppliers, that the price leader misjudged his own interest, and that the other members did not abandon collusion (their parties) in time. *To call the devaluations, which ultimately resulted, "beggar-thy-neighbor policies" is to misjudge the case completely;* for, given the U.S. monetary contraction, devaluation vis-à-vis the dollar was required to stop the price level from declining in the rest of the world. The justification was price level stability, not international competitiveness.

What has been said about monetary policy coordination is not true for international cooperation in the field of trade relations. This is because trade restrictions interfere with the market process and impose Pareto-relevant externalities on other nations. Thus, there is a sound economic case for international trade agreements to avert protectionism.

Roland Vaubel is a member of the Institute of World Economics in Kiel, West Germany.

In Defense of Bank Failures

by Lawrence H. White

The degree to which a number of American banks have exposed themselves to the threat of loan default or debt repudiation by the governments of several developing nations is alarming. It raises a critical public policy question: should the United States' monetary authorities be advised to allow major banks to fail on account of bad loans? Or should their money-creating powers be used to support the banks? Roland Vaubel's answer, in capsule form, is: the authorities can and should liquidate insolvent banks, whatever their size, provided that they do not allow the money supply to contract as they did in the 1930s.

Lawrence H. White is a professor of economics at New York University.

There are basically two ways of arguing the case that insolvent banks should be allowed to fail: First, that it is the expedient thing to do; second, that it is the just thing to do. Vaubel makes the expediency case primarily on two grounds. His first ground for a willing-to-liquidate-failures policy is the interesting idea that a creditor nation's government's readiness to allow domestic banks to fail is an effective tool in resisting possible "blackmail" threats from the debtor nations' governments. These threats presumably take the form: extend me further subsidized credit or outright aid, or I'll default on my debt obligations to your banks. (Technically one should consider this extortion rather than blackmail, the difference being that a blackmailer is entitled to do that which he threatens.)

The desirability of resisting such threats from the point of view of the representative citizen of the creditor nation should be clear: domestic government grants to a debtor nation government for the purpose of forestalling default, financed by money-creation or overt taxation, amount to nothing more than roundabout transfers from other domestic citizens to the shareholders of the threatened banks. The taxpayers are being asked to bail out the banks. If they wished to do so (surely not all do) they could do so domestically, cutting out the debtor-government middleman. It is doubtful that a million dollars transferred to default-threatening governments will often enrich domestic bank shareholders by as much or more than a million dollars, i.e., will result in more than a million dollars of debt being repaid that would otherwise have been repudiated. An "investment" of this sort with an unwilling debtor is unlikely to pay a positive rate of return. In the event that it does seem likely to, the creditor banks should be fully willing to extend aid at their own expense.

Thus, as Vaubel indicates, the creditor banks can and should be left to make the decision on whether the act of lending a debtor nation the money it claims to need to cover its interest payments is an act likely to reduce or increase the loss of principal. Willingness to let banks fail is the only way to keep banks from shifting the burden of a mistaken decision onto taxpayers and base-money-holders. Keeping the costs and benefits of a decision internal to the decision-maker is, of course, the only way to insure that a prudent decision is made.

A policy of insuring every large bank against failure—no matter how egregious the loan policies that rendered it insolvent—creates a moral hazard problem of potentially huge dimensions. It attenuates the proper incentives for large banks to loan out their funds prudently. (Regrettable as the monetary and real-side shocks of the past decade have been, it is difficult to accept the argument that no imprudence should be seen in the banks' failure to prepare for the possibility that a serious recession could sour their loans to less developed countries.) If loan losses in excess of equity do not force a bank into liquidation, then the risk that losses will exceed equity will no longer enter the bank's decision calculus with a heavy enough weight. If bankers who make unprofitable loans are not forced out of business, the economy's scarce loanable funds (and the complementary resources that go into banking) will not be directed to their most productive uses. Allocative efficiency requires that major banks be as free to fail as firms in other industries.

Vaubel's second ground for the expediency of letting insolvent banks be liquidated in timely fashion is that this policy actually reduces the risk of a banking panic. Depositors may run on a bank if they fear that it is insolvent, and hence unable to redeem the claims of all but the first in line to demand redemption, yet the bank remains in business. A policy of promptly liquidating insolvent banks before their net worth falls too far below zero will accomplish two things: (1) it will limit the losses of bank liability-holders or whomever else bears the deficiency (in particular those who bear the burden of funding deposit insurance) in each particular case, and (2) it will reassure depositors that functioning banks really are solvent.

The ethical case against increased monetary base expansion or tax-subsidized lending to debtor governments as methods of aiding domestic banks is simply that bank shareholders are not entitled to involuntary transfers from money-holders or taxpayers. It is obvious that aid grants or lending programs are redistributive when financed by explicit taxation. They are no less so when financed by an expansion of the monetary base that covertly taxes holders of existing base money by diluting the value of their holdings. Indeed any injection of new base money is redistributive unless granted proportionately to holders of existing base money, regardless of whether its ostensible purpose is to forestall a recession or a banking panic.

A final note: One sensible measure that American monetary authorities might take to lessen the chance of a banking panic relates to their regulatory powers rather than their control over the money supply. They could eliminate the archaic ban on interstate branch banking, which prevents banks from reaching the optimal size for risk-spreading purposes. It may be noted that Canada, with its banks allowed to branch nationwide, experienced no bank failures and no runs on the banks during the Great Depression. ■

A Note to Our Readers

Beginning with the next issue, the Cato Institute will combine its two newsletters into one publication, to be known as *Cato's Letter*. *Cato's Letter* will appear six times a year and will continue to contain most of the material now in *Policy Report*—original articles on economic policy, transcripts of Cato Policy Forums, book reviews, and of course "To be governed . . ."

The new publication will have additional space for op-ed pieces and "Byline" radio commentaries produced by the Cato Institute, reports on Cato conferences and policy studies, and news about the Cato Institute and its adjunct scholars. All *Policy Report* subscribers will receive *Cato's Letter*, and their subscriptions will be extended to include the same number of issues originally purchased. The Cato Institute believes that this new publication will be even more useful to its readers.

Gold, Oil, Trade, and the Debt Crisis

Constructive Approaches to the Foreign Debt Dilemma, *edited by Mark Hulbert and Eric Meltzer, (Washington, D.C.: Taxpayers' Foundation, 1983), 78 pp., $4.00.*

International Debt and the Stability of the World Economy, *by William R. Cline, (Washington, D.C.: Institute for International Economics, 1983), 134 pp., $6.00.*

A Monetary Agenda for World Growth, *edited by Jack Kemp and Robert Mundell, (Boston: Quantum Press, 1983), 133 pp., $9.95.*

Deferred Future: Corporate and World Debt and Bankruptcy, *by Dan Dimancescu, (Cambridge, Mass.: Ballinger Publishing, 1983), 162 pp., $17.95.*

Despite the tremendous quantity of resources that have been invested in studying the issues of foreign debt and the international monetary order, the general quality of the resulting discussion has been almost uniformly low. The economic causes and consequences of debt rarely receive more than perfunctory attention, as most of the debate centers around political issues and pressure groups. For instance, fundamental changes in banking and monetary institutions are usually not discussed. Instead, it is simply assumed that the Federal Reserve and Treasury must continue their current roles in the U.S. economy and bail out the American banks. At this point the debate quickly shifts to the question of who can formulate the most plausible plan to patch up the numerous holes in the status quo. After the patchwork is completed, it is assumed that "business as usual" should be the order of the day.

In those instances where economic reasoning is applied to the debt problem, the proffered arguments are almost always bad. For instance, the Treasury has claimed that the GNP will increase by three dollars for every additional dollar that the U.S. contributes to the IMF. During the debate over the proposed $8.4 billion increase in the American contribution to the IMF, it was not uncommon to hear arguments that the quota increase would save the international monetary system from disaster, boost American exports, substantially increase American employment, and prevent the nationalization of the U.S. banking system.

The first book under consideration, *Constructive Approaches to the Foreign Debt Dilemma*, largely avoids these problems, as many of the contributors utilize sound economic analysis *and* question the fundamental assumptions behind standard analyses of the debt problem. The book is essentially a collection of transcribed talks (from a conference) on the debt problem. The speakers include Allan Meltzer, Anna Schwartz, Karin Lissakers, Gordon Tullock, Michele Fratianni, Sir Alan Walters, and Milton Friedman. Some of the question-and-answer sessions are also reproduced. While the quality of

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the material in this book varies considerably, most of it is quite interesting.

Perhaps the best talk in this volume is the opening lecture by Allan Meltzer entitled "Five Reasons for Opposing the IMF Quota Increase." In this brief speech Meltzer makes several important points that have largely escaped the attention of the media, Congress, and the Reagan administration. Meltzer argues that an IMF bailout would only prolong the present uncertainty over the debt situation without providing any actual resolution of the problem. Only if there were reason to believe that the debt problem would be substantially alleviated in the future would the quota increase make sense, since all it does is buy a little more time (at the expense of the American taxpayer, of course). Another reason for opposing the quota increase is that it will be used for the IMF's conditional lending program. Meltzer makes an excellent point about IMF lending: "Conditionality requires a country to agree to policies which cause a decline in real income and imports from the rest of the world . . . The idea is that a country lowers production costs and brings its balance of trade into surplus . . . But applied *multilaterally* to countries that are each other's customers, this policy makes much less sense, indeed very little sense at all. The reason is that Mexico, Argentina, Brazil, and the United States are linked together. When Mexico curtails its imports it curtails Brazil's exports . . . The IMF policy is a contractive policy for the world as a whole. It is, when judged *multilaterally*, a program that hurts many of the countries that it is supposed to help by shrinking the size of the world economy, contracting the amount of trade, and reducing the amount of exports."

Other interesting points in this book include Anna Schwartz's argument that defaults would not lead to a bank collapse, Sir Alan Walters's brief remarks on other debt "problems" in history, Milton Friedman's comments on the role of the IMF, and Gordon Tullock's analysis of debt repudiation. As one might expect from the list of contributors, most of the talks represent a market-oriented view of debt and development.

Another recent book on debt, William Cline's *International Debt and the Stability of the World Economy*, lacks both the polemics and the excitement of the Hulbert-Meltzer collection. Nonetheless, it is a valuable source of facts and references for anybody interested in researching the debt problem. Cline presents careful factual studies and explanations of such topics as the role of oil prices, the role of interest rates, the extent of bank exposure, the potential consequences of a moratorium, "involuntary" lending, rescheduling techniques, bank regulations, and different proposals for reform. For such a slim book, Cline packs in an admirable amount of useful information and statistics.

Despite such praise, the analysis offered in Cline's book is not satisfactory. Perhaps the most serious flaw with this volume is that Cline has no adequate theory of why overlending occurred in the first place. For Cline, the main culprit is the skyrocketing oil prices of the 1970s. Yet, how does this explain the debt problems of such *oil-exporting* nations as Mexico, Venezuela, Nigeria, Indonesia, and Ecuador? In fact, the

ratio of the 1982 debt of these countries to their 1973 debt is higher than the equivalent ratio for non-oil developing countries. The oil-price theory also fails to explain why overseas lending increased dramatically *before* OPEC raised the price of oil. Cline's book would have been much stronger if he had spent more time looking at the other factors behind bank overlending. However, we find no analysis of the move to floating exchange rates in the 1970s, the expansionary U.S. monetary policy throughout much of the last decade, the strong political pressures exerted on banks to lend abroad, the widely held belief that Uncle Sam will bail out any bank in trouble, Regulation Q and the growth of the Eurodollar market, restrictions on interstate branch banking, and changes in the Interest Equalization Tax. Of course, one need not be very perceptive to notice that all of these causes emanate from the *public sector*, not the private sector.

The lack of a good explanation for bank overlending also results in bad policy recommendations from Cline. While many of his suggestions are quite sound (such as lower deficits and hence lower interest rates), Cline also calls for an increased role for multilateral aid and lending agencies as well as new regulations on banks. The problem with such proposals is that the history of the debt crisis quite emphatically demonstrates that the public sector does not possess any more wisdom or prudence in this area than the private sector. Indeed, it may not even possess nearly as much foresight. Perhaps the best feature of Cline's policy analysis is his excellent critique of some of the more ambitious regulatory plans (such as the Kenen and Rohatyn proposals) for solving the debt crisis.

The third book under consideration, *A Monetary Agenda for World Growth*, covers many of the weaknesses of the Cline book. Consisting of a series of transcribed talks from a conference, this book addresses fundamental issues regarding the international monetary order. Among the contributors are such well-known political figures as Jack Kemp, George Shultz, Beryl Sprinkel, Donald Regan, and Henry Kissinger, and academics like Robert Mundell, Arthur Laffer, W. H. Hutt, Charles Kindleberger, Gottfried Haberler, Robert Triffin, Paul Craig Roberts, and Jacob Frenkel.

While *A Monetary Agenda for World Growth* contains little direct discussion of developing-country debt, it is still an interesting book for those wishing to study the problem. Perhaps the central theme of most of the talks in this volume is that the elimination of gold backing for Federal Reserve notes (1968) and the move to floating exchange rates (1971-1973) are largely responsible for the international economic chaos that has prevailed over the last decade. This argument is best summed up in Mundell's opening talk. Mundell blames floating exchange rates for investment uncertainty, the increase in inflation in the 1970s, high interest rates, increasing pressures for protectionism, and the mushrooming LDC debt problems. Defending floating rates are Shultz, Haberler, and Otmar Emminger. Those economists argue that while fixed rates have certain attractive features, they are both institutionally unfeasible and would be a source of systematic disruptions in the international economic fabric. (For a discussion of the fixed rate-floating rate debate, the reader is referred to Lawrence White's "Fix or Float?" in the November 1983 issue of *Inquiry*.)

However, the relevant feature of this volume is its brief and scattered remarks on the place of the Third World in our current international monetary system. For instance, Robert Mundell pointed out that the status quo mixture of fixed and floating rates gives LDCs the worst of both worlds. As Mundell notes, "We had the case of Mexico which, from 1954 to 1976, had a peso worth eight cents. The ratio was 12.5 to the dollar. For over 20 years, Mexico kept that fixed exchange rate system and until the oil boom, a rate of inflation that was about the same as the U.S. rate of inflation. After Mexico gave up its fixed exchange rate, fiscal and monetary discipline broke down and prices since 1975 have risen more than 400 percent." However, even if LDCs stick to a fixed rate, serious problems may still arise. Mundell points out that there are two different notions of fixed exchange rates—those that are pegged to another currency (the status quo for most LDCs) and those that are pegged to gold. In the former case "it is only when . . . one adopts fixed exchange rates as a mere peg, and the central bank sterilizes the monetary effects of intervention by offsetting the automatic tightening or loosening of the money market that fixed exchange rates become a source of disequilibrium."

The final book under review, *Deferred Future: Corporate and World Debt and Bankruptcy*, argues that debt and bankruptcy have become institutionalized features of the American economy in the 1970s and 1980s. Dimancescu examines the Penn Central bankruptcy, the fiscal crises of New York City, business bankruptcies, and Third World debt. He labels the 1970s "the decade of the financiers," since the obligation to repay debt has lost much of its meaning. Dimancescu then shows how handling debt and bankruptcy has become a thriving Wall Street business.

Unfortunately, like Cline's book, Dimancescu's work provides no convincing explanation of how debt problems became so important in a relatively short period of time. The only analysis offered concerns the effect of bankruptcy laws on debt. Dimancescu endorses such laws, as he believes that everyone should have a "second chance" after a major business or banking failure. Yet there is no discussion of the incentive effect of bankruptcy laws on the actual number of failures. Dimancescu is equally unconvincing with respect to policy recommendations. His primary suggestion is that we should write off much of the accumulated debts and "settle for less." While this may not be a bad idea, it is not a sufficiently penetrating suggestion to warrant much special attention.

Of the four books under consideration, *Constructive Approaches to the Foreign Debt Dilemma* is definitely the most interesting. Not only is it both readable and enjoyable, but it asks the right questions—even if it does not always produce satisfactory answers. The three other books will have interesting particular aspects, but the reader is given no accurate guidance as to how to put the entire picture together. At this point, at least one thing is clear—a satisfactory comprehensive study of the causes and consequences of the debt problem has yet to be written. ■

—Tyler Cowen
Harvard University

"To be governed . . ."

Profiles in courage

U.S. Rep. Phil Gramm, who seeks the Republican nomination to the U.S. Senate for Texas, said Thursday in Marshall that normal revenue growth would make a balanced budget possible over the next few years "without making a single cut in any program."

—*Marshall* (Texas) *News-Messenger*, Jan. 13, 1984

That's a relief

"We have never seen such freedom, since the kingdom. People say whatever they want to say, there's no kind of restrictions, unless something is against the law."

—Interview with Egyptian President —Hosni Mubarak in the *Washington Post*, Feb. 15, 1984

Dividing up the loot

The 20 members of the powerful House Appropriations Committee [of the Virginia legislature] met for a marathon 12-hour session to tinker with Gov. Charles S. Robb's $15.8 billion budget. . . .

Hour after hour, they voted thumbs up or down on more than 300 spending amendments. Shouting out their preferences, they were accountants one minute and poker players the next.

"Well, I just lost $100,000 like that," said a momentarily dejected Del. Alson H. Smith (D-Winchester) after committee chairman Richard M. Bagley had halved his request for nursing-student loans. He thought a moment, then brightened. "But I got my nursery, and $100,000 for the wine promotion, so I guess I did all right."

—*Washington Post*, Feb. 20, 1984

A healthy regard for the taxpayer's dollar

Two of the men who led the fight two years ago to include hospice benefits in the Medicare program . . . have formed a company that hopes to start a chain of money-making hospices.

—*Washington Post*, Feb. 22, 1984

The $925 billion campaign

"The law says the president shall propose a budget each year containing what he thinks is best for the nation," notes one administration economic aide. "This [1985 Reagan] budget says he clearly thinks his re-election is best."

—*Newsweek*, Feb. 13, 1984

The alliance for what?

In a petition filed recently with the Commerce Department, the American Grape Growers Alliance for Free Trade called for the assessment of antidumping penalties and countervailing duties on low-priced wines imported from France and Italy.

—*Newsweek*, Feb. 27, 1984

Regulation and the public interest

A large number of District residents with close ties to elected officials and high-ranking city employees hold interests in the three firms that are bidding on the city's cable television franchise, a review of corporate records indicates. . . .

Several of the three firms' key investors and officers . . . have political ties to the District Council members who will award the high-stakes contract later this year.

Other investors . . . are politically close to Mayor Marion Barry.

"It's going to be a political decision and it's going to end up in the courts," said a council member. . . . "Most of the players are political, and all of them have strings they can and will pull."

—*Washington Times*, March 1, 1984

That's what they all say

Larry Bozo Harmon, the man who originated "Bozo the Clown," has decided to run for president of the United States. . . . Harmon is serious.

—*Washington Post*, Feb. 23, 1984

Sludge funds

Mayor Marion Barry's 1982 campaign chest received an extraordinary array of contributions from sewage-sludge processing and hauling companies that have been awarded more than $20 million of mostly unbid District contracts over the last two years, campaign records reveal.

—*Washington Times*, Feb. 27, 1984

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