Cato Policy Report

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Federal Deposit Insurance Source of S&L Crisis

by Catherine England

Politicians, the media, and the general public finally are waking up to the existence of a longstanding crisis in the savings and loan industry. Current losses, estimated at $125 billion, are now large enough to capture attention, even in Washington. Unfortunately, most of the political rhetoric and news analyses concerning the savings and loan crisis have focused on the wrong issues. The partial deregulation of the industry that took place in 1982 did not cause the fiasco. Nor is funding the cleanup the most important issue with which Congress should wrestle in the next few months.

Since President Bush's plan for resolving the thrift industry problem was announced, it has served as the starting point for many news discussions. The plan is also a useful example of how the debate over structural reform of the industry is being directed onto a road that offers little promise of arriving at a permanent solution to the fiasco.

Catherine England is director of regulatory studies at the Cato Institute.

The Bush proposal for addressing the savings and loan industry crisis offers a plan for funding the cleanup and suggests reforms that President Bush argues will prevent similar problems in the future.

The Bush Plan

Briefly, the president expects that dealing with the insolvent S&Ls will cost $90 billion plus interest. If the Bush plan is adopted, the money necessary to pay insured depositors in decapitalized institutions would come from newly issued 30-year bonds. Taxpayers would be responsible for at least half of the interest, and thrift industry resources would be tapped to pay the remaining interest and repay the principal. The promise that industry resources will absorb a large portion of the costs allows most of the funding requirements to be kept off the federal budget (at least for now), thus minimizing the impact on the reported deficit. The total cost of the 30-year package could easily reach $200 billion when interest is included.

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Sen. Phil Gramm addresses opening session of Cato's Seventh Annual Monetary Conference, "Alternatives to Government Fiat Money."

President Bush also has resolved to provide tougher regulation. The administration's proposal would give the Justice Department an additional $50 million to beef up its program to prosecute depository managers suspected of fraud or malfeasance. In addition, the Federal Savings and Loan Insurance Corporation (FSLIC) would be separated from the Federal Home Loan Bank Board and placed under the supervision of the Federal Deposit Insurance Corporation (FDIC), though the funds of the two agencies would remain separate. The administrative structure of the Federal Home Loan Bank System would also be changed. The three-member board would be eliminated, and the system's chairman would serve in the Treasury Department just as the comptroller of the currency, the overseer of nationally chartered banks, is housed within Treasury. The suggested reforms seek to recast the thrift industry regulatory structure into a mold more like that of the banking industry. It is widely believed that bank

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Europe, America, and 1992

Chairman's Message

The European Economic Community is embarked on an ambitious project with implications for both Europe and the rest of the world: the creation of a genuine free-trade area by the end of 1992. Although free trade within Europe was the principal objective of the Community's founders, many government-imposed barriers to the movement of goods, services, labor, and capital among the 12 member nations are still in place. The 1992 project is primarily intended to remove those barriers.

A direct result of free trade will be a significant increase in average productivity and real per capita income in Europe. As Adam Smith observed two centuries ago, "The division of labor is limited by the extent of the market," and the 1992 project promises to create the world's largest market. Perhaps more important, free trade will reduce each member government's ability to exploit its citizens. Moreover, the free movement of labor will change the demography of Europe, reducing the heterogeneity among the member nations but increasing the heterogeneity within each nation—a development that will have profound cultural and political effects. In that respect, Europe will become more like the United States.

The creation of a genuine free-trade area will have two major effects on the United States and other nations outside the Community. First, for firms establishing operations in Europe, the choice of location will become more dependent on the relative costs of production and less dependent on the relative sizes of national markets. That change, which will lead to increased economies of scale for European firms as well, will most benefit the European nations with the lowest costs.

Second, the creation of a free-trade area will affect the volume of each nation's exports to Europe. Whether a specific nation increases or decreases its exports will depend on whether the Community's harmonization of external trade barriers involves an increase or a decrease in the average effective tariff on such exports. The Community should reduce external trade barriers in concert with eliminating its internal trade barriers, but it is unlikely to enact such a provision except as part of a broader multilateral agreement.

Aspects of the 1992 project that represent movement in the direction of a European state, including attempts to harmonize the tax rates and regulations of the Community's member governments, are more ominous. The politics of collective harmonization is likely to bring about a net increase in tax rates and regulation, which will offset the benefits of a free-trade area. The Eurocrats in Brussels seem to believe that nothing good can happen unless it is planned and directed from the center. But a spontaneous, uncoordinated harmonization would occur in a genuine free-trade area—a process that would lead to a leveling down, rather than a leveling up, of taxes and regulation.

A condition permitting such a spontaneous harmonization in one arena, however, will be in force: In the absence of a Community-wide regulation, the regulation of each member government will apply throughout the Community. A German product sold in France, for example, will be subject to German regulations; a lawyer qualified for the bar in Italy will be able to practice in Britain. Each member government will thus be pressured to eliminate or relax regulations that do not serve the interests of consumers. Unless overridden by Brussels, the resulting interjurisdictional competition will be more powerful than the competition among the American states.

In short, the Community is trying to do too much. It should create a genuine free-trade area and allow the spontaneous process of harmonization to discipline the tax and regulatory policies of each member nation. The other aspects of the 1992 project will only increase the role of government in Europe, to no one's benefit.

—William A. Niskanen

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Privatize Money?

Conference Looks at Alternatives to Central Banking

Nobel laureate and Cato distinguished senior fellow James M. Buchanan, Sen. Phil Gramm, Genie Short of the Federal Reserve Bank of Dallas, and Auburn University's Leland Yeager were among the speakers at the Cato Institute's seventh annual monetary conference.

The conference, "Alternatives to Government Fiat Money," was made possible by a grant from the George Edward Durell Foundation and focused on questions of free banking and private currency issuance. The idea that private-sector currencies are both feasible and desirable has been strengthened in recent years by the interest accorded it by Nobel laureates Milton Friedman and F. A. Hayek (also a Cato distinguished senior fellow). As a *Forbes* article recently noted, "Privatized money, alias 'competing currencies' or 'free banking' is an idea that you will be hearing much more about in the years ahead."

In the conference's closing talk, Jerry L. Jordan of First Interstate Bancorp proposed several immediate reforms that would "facilitate the evolution away from the present governmental, discretionary fiat monetary system," which has failed to bring about monetary stability. His proposals included a treaty with other industrialized nations to limit the growth of the money supply, an end to the Federal Reserve's open market operations, elimination of reserve requirements on "alternative moneys" such as travelers checks issued by commercial banks and electronic currency, and legislation to make contracts written in terms of alternative currencies legally enforceable.

Buchanan criticized orthodox macroeconomics for conceiving of "the economy as an independently existing organic unit, to which purpose can be assigned" rather than as a "structure or order, described by a set of rules, and within which separate individual actors pursue individually selected objectives."

Lawrence H. White, Cato adjunct scholar and a professor of economics at the University of Georgia, said, "We should keep in mind that the ingenuity of potential monetary entrepreneurs makes it impossible for any economist

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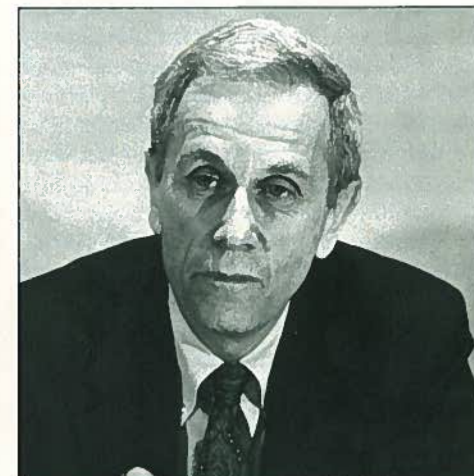
Richard N. Cooper of Harvard and Lawrence H. White of the University of Georgia debate competitive money.

Chamber of Commerce chief economist Richard Rahn says private money might begin in Eastern Europe.



Former Volcker aide Stephen Axilrod questions whether private money's time has come.

Former senator Eugene J. McCarthy talks with Norman B. Ture of the Institute for Research on the Economics of Taxation at Cato's monetary conference.

Speakers from Hong Kong and Peru Highlight Forums

Cato Events

December 5: **"A Phoenix in Zion: Reviving the Israeli Economy."** Cato adjunct scholars Alvin Rabushka of the Hoover Institution and Steve Hanke of Johns Hopkins University discussed their recent study, "Toward Growth: A Blueprint for Economic Rebirth in Israel." They contended that Israel's political economy is in dire need of structural reform and urged that Tel Aviv undertake a number of tax, budget, and monetary reforms, including privatization, reduction of public spending, and aggressive income-tax rate cuts.

Beryl Sprinkel and William A. Niskanen, who were both members of President Reagan's Council of Economic Advisers, discuss President Bush's economic policy.

December 15: Book party for George A. Selgin, author of ***The Theory of Free Banking.*** Selgin, a professor of economics at the University of Hong Kong and an adjunct scholar at the Cato Institute, refuted the common assumption that central banking—manifested in a government monopoly of the supply of currency—is indispensable to monetary stability. He showed how particular banking institutions and procedures would develop in an unregulated environment and presented evidence that a free market for money offers greater hope of achieving stability than either monetary rules or a monetary authority.

January 11: **"Would Protectionism Weaken the Oil Industry?"** Cato adjunct scholar Robert L. Bradley, Jr., author of the recent Cato book *The Mirage of Oil Protection,* argued that imposing a tariff or some other fee on imported oil would not alleviate depressed oil industry profits but would instead harm consumers, workers, and even its oil producer "beneficiaries." He urged policymakers to let the price of oil alone, and he advocated a program of market-oriented reform in the areas of taxation, regulation, and privatization.

January 12: The Cato Institute hosted a reception in honor of the publication of its book ***An American Vision: Policies for the '90s,*** edited by Institute president Edward H. Crane and vice president David Boaz. More than 400 people gathered at the Willard Hotel for the event. The book—which the *Washington Post* said proposes "the most radical reduction of U.S. government activities . . . yet suggested by any serious policy organization"—contains essays by 21 noted scholars and policymakers, including George Gilder, William Niskanen, Earl Ravenal, Pete du Pont, Catherine England, and Peter J. Ferrara.

January 27: **"Civil Rights Policy: Are We All Included?"** William B. Allen, chairman of the U.S. Commission on Civil Rights, argued that the American civil rights community should focus its energies not on expanding entitlement programs for members of the underclass but rather on finding ways of allowing those people to become self-reliant.

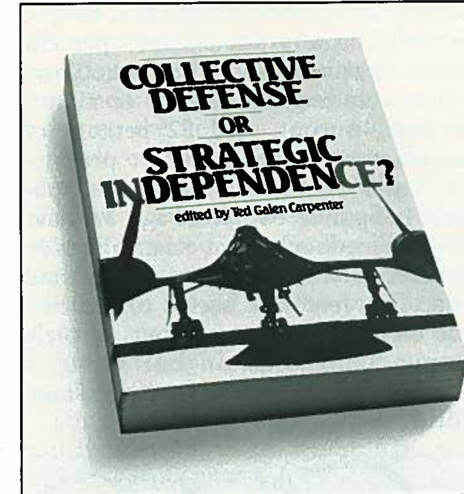
David S. Broder of the *Washington Post* talks with Civil Rights Commission chairman William B. Allen after Allen's Cato Policy Forum talk.

February 8: **"The Other Path."** Hernando de Soto, founder of the Institute for Liberty and Democracy in Peru and author of *The Other Path: The Invisible Revolution in the Third World,* discussed the informal economy and the need for a rule of law in Peru and other Third World countries. ■

Time to Withdraw?

Scholars Debate Benefits, Costs Of U.S. Military Alliances

For the past four decades, the twin doctrines of containment and collective defense have guided U.S. defense policy, presenting international politics as a battle between two superpowers and viewing European and Asian allies as essential to U.S. security. In a new book from the Cato Institute, 16 distinguished experts criticize these policies and offer incisive proposals for reform.



Collective Defense or Strategic Independence?, copublished by the Cato Institute and Lexington Books, was edited by Ted Galen Carpenter, Cato's director of foreign policy studies. The book includes essays by scholars of divergent views, ranging from opponents of collective defense such as Earl Ravenal to ardent defenders such as Eugene Rostow. Authors include Stephen Walt, Alan Tonelson, Christopher Layne, Melvyn Krauss, Aaron Wildavsky, Edward Olsen, and others.

Much of the book concerns NATO. With more than 300,000 U.S. soldiers stationed in Western Europe and a cost to U.S. taxpayers of some $124 billion annually, NATO represents a mammoth commitment. But as Carpenter notes, the architects of NATO "did not assume that the United States would have to bear the predominant portion of the burden indefinitely." Those leaders "looked forward to the time when the nations of Western Europe would recover from the devastation of World War II and would be able to assume primary responsibility for their own defense."

In an ambitious proposal for a mutual superpower withdrawal from central Europe, Cato adjunct scholar Christopher Layne maintains that Western Europe could deter Soviet aggression without a massive U.S. military presence on the continent. According to Layne, Washington could seize the diplomatic initiative from Moscow and win the battle for European public opinion by promoting such a withdrawal.

Other sections address U.S. policy in Asia and the proper U.S. role in the Third World. Edward Olsen of the Naval Postgraduate School calls upon Tokyo to play a larger role in defending the Pacific Rim, noting that "there is something terribly wrong with a strategic relationship in which one economic giant does so much more than the other economic giant." And Terry Deibel of the Naval War College asserts that Third World neutralism does not menace U.S. security interests and that Washington gains little by pressuring reluctant developing nations into defense commitments.

The volume concludes with an assessment of containment's overall effectiveness. Foreign policy analyst Alan Tonelson says that U.S. policy has been based on a reflexive obsession with a vaguely defined Soviet threat and argues that the United States should jettison unnecessary commitments and pursue a policy based on its own interests instead of those of its allies.

Cato adjunct scholar Earl Ravenal contends that "limited containment" is an oxymoron and that the only viable containment strategy is one that counters Soviet probes wherever they occur. But "there is a price to be paid" for such an extensive commitment, he writes, "and that price has been growing higher." He predicts that the American people will not bear those costs indefinitely.

Collective Defense or Strategic Independence? is available from the Cato Institute in paper for $14.95 and in cloth for $43.95. ■

Audiences in Japan, Europe Hear Niskanen

Cato Institute chairman William A. Niskanen has had an active international speaking schedule in recent months, addressing audiences in Japan, China, France, Ireland, Germany, Great Britain, and Israel. Niskanen, a former member of President Reagan's Council of Economic Advisers, is a frequent commentator on the Reagan economic record and a widely quoted analyst of trade, fiscal policy, and other economic issues.

Speaking to the Institute of Public Affairs in Dublin, Niskanen argued that the economic failures of the Republic of Ireland spring from that country's emulation of a form of the creeping socialism espoused by the British Fabian Society of the late 19th and early 20th centuries. Niskanen urged the Irish to look to the experience of New Zealand—like Ireland, a former British colony with a Labour government—in formulating a new economic policy. New Zealand has made extraordinary economic gains by implementing an expansive program of tax reform, deregulation, and privatization.

In an address to the German Legislators Association in Bonn, Niskanen reviewed the record of deregulation in the United States and considered its implications for West Germany and America. He noted the enormous savings to U.S. consumers spawned by partial deregulation of a number of industries but argued that more extensive regulatory reform continues to be needed.

In a speech to the Israel Center for Social and Economic Progress, Niskanen looked at the behavior of bureaucracies and its effect on the public interest. He noted that bureaucracies "generally serve the public interest only when the political authorities reward a bureau based on a performance standard consistent with the public interest." However, current institutional incentive structures improperly reward bureaucratic growth and power maximization at the expense of efficiency and public service. ■

The Free Market Path to Third World Development

Policy Forum

The Cato Institute regularly sponsors a Policy Forum at its Washington headquarters, where distinguished analysts present their views to an audience drawn from government, the media, and the public policy community. A recent forum featured Hernando de Soto, founder of the Institute for Liberty and Democracy in Peru and author of The Other Path: The Invisible Revolution in the Third World *(Harper & Row, 1989).*

Hernando de Soto: The Institute for Liberty and Democracy was formed in Peru to try to find out why we were poor. We didn't necessarily believe that Peruvian culture was an obstacle to wealth, and we wanted to find out if the problem was something easier to change than culture—such as legal. We were aware that the arguments of people who believed in market economics were not able to catch on in Peru. The notion of class was one that fascinated us. Maybe the people who were talking about markets and democracy were not talking to the right people.

In that connection, we became very interested in what was known as the informal sector—the underground economy—because one of the principal characteristics of the poor in Peru was that they operated outside the law. Yet when going through existing literature on informality, we never saw a book, a chapter, or even a sentence in the 130 books written in Peru on informality that dealt with the legal questions. We defined informality as the use of illegal means to achieve legal objectives: that is, disobeying regulations for legal purposes such as building a house or manufacturing or selling a product, as opposed to illegal means to achieve illegal objectives such as the drug trade.

Most of our work during the first years was to try to measure illegality. We were able to establish that such illegal activities compose about 61.2 percent of all manhours worked in Peru, and they produce approximately 35 to 40 percent of the gross national product of Peru. Today illegal enterprises are producing more than 7 out of every 10 homes built in Peru. People working illegally make up 95 percent of the transport trade. They are 60 percent of retailing, 30 percent of manufacturing output, and 52 percent of manufacturing enterprises or production units. Since our book was published in Spanish two years ago, we have received feedback from other places in Latin America and from Africa and Asia. This feedback seems to indicate that we're not talking about a solely Peruvian phenomenon but rather a common phenomenon in the Third World.

Hernando de Soto: "Illegal activities compose about 61.2 percent of all manhours worked in Peru, and they produce 40 percent of the GNP."

We tried to find out why people were working illegally, and again we tried to find ways of measuring the cost of law. The most obvious cost was the amount of time required to deal with red tape to enter the market. That's how we did our now somewhat famous experiment of actually simulating a garment workshop with two sewing machines. It took us 289 days of working 6 hours a day to register this shop, as opposed to conditions in New York where it took us only 4 hours. In other words, a Peruvian entrepreneur had to work 700 times harder than a United States entrepreneur just to get inside the market. We found out of course that this did not relate only to manufacturers; it also related to housing. For example, since most Peruvians cannot actually work in the center of town where real estate values are much too high, they have to go to the outskirts of town where most of the land is owned by government. If they were to try to obtain the land through normal adjudication procedures, it would take, as our simulation indicated, 6 years and 11 months of working 8 hours a day—if, for instance, you are the head of a 100-family housing project. In that process you would fill in 207 documents and visit 52 government offices.

Regarding street vendors, who we found had built 274 of Lima's 331 markets, we found that the figure could have been even greater—if it didn't take 12 years between the time the street vendors get organized and the time that the government permits them to build on the land that they have bought.

We were able to see that it was not that in Peru we had markets and they failed because culturally we Latin Americans aren't made for markets—we have a more family-oriented philosophy, or we're just better at the guitar than at work. It was actually that the law was very hard to overcome—it was an obstacle.

Next we found that not only are the costs of entry enormous, there is also the cost of just staying in business; of every $7 that a small enterprise has to pay the government in Peru, $1 is in the form of taxes and $6 is for bureaucratic and social costs and graft. These expenses largely explained why most of Peru operates illegally. The problem is the law, and the law is something identifiable that you can change. If the problem were purely cultural, then you are in trouble because how do you change your culture?

Now the question remains as to why there is little or no progress in the informal sector. Does that constitute proof that even where Latin Americans don't have all of these restrictions, they are not able to prosper? But then we found out something very important: Freedom is not a condition of no law. Freedom is also a condition of having adequate legal institutions that allow people to carry out transactions among themselves in a less costly way. One problem of the informal sector was not that it had bad law, but that it had a lack of good law.

What is good law? Good law is property rights, for example. Take two people living in a "Young town" or informal settlement, one of whom has title to land. You will find that after 10 years people who have title to the land will have increased the value of their homes nine times more than those who do not have title. When you withdraw uncertainty, people will invest—whether they are oil men, or poor people. In Peru only 3.5 percent of total homeowners have adequate titles, so people don't maintain investments. It's not enough simply to have freedom, you need a good titling law.

If you are not well titled, you have no access to credit. In the United States, 80 percent of small enterprises are financed by mortgage loans. But you can't use your home as collateral if nobody knows you own it. Underdevelopment in the informal sector is quite explainable in the sense that you have no title, therefore you have no collateral, therefore you have no access to credit. The banking reform that Peru needs is not to nationalize banks but to give titles to people so they can use their collateral to get into the banks and break the oligopoly that now exists. Another problem is that businesses in the informal sector are not registered, so they can't form corporations. The informal sector has to work with unlimited liability. Limited liability is a legal concept; it lets you and your partners know what you are risking. In the informal sector, when someone conducts a bad venture, he loses everything. So it is a world of enormous uncertainty. It is also a world where you do not have insurance with which to distribute risk.

Because you do not have torts law, private enterprise is extremely unpopular. I hear that many people in the United States would like to privatize the transportation system. Let me tell you, we've already done it in Peru and it doesn't work—because the law is not adequate. In Lima, 95 percent of public transportation is informal. The average bus fare in Peru is 9 American cents per ride, and yet 90 percent of the people agree that you should liquidate that private transportation system and create a public system. But such a policy would create an additional $2 billion in foreign debt. The problem is that everybody hates the bus drivers and the truck drivers because there is no way to get at them when they have an accident.

That is, private transactions produce what economists call negative externalities. If you don't have courts and torts law, then there is no way of actually reducing the negative externalities. As a result of which, private business is generally unpopular. That's why street vendors would like to see the bus drivers expropriated, farmers would like to see all industries expropriated, and industrialists would like to see farmers expropriated—because there is no way to correct the deficiencies of private transactions.

Thus the law is enormously important for development. If you have bad law, you can't develop. It is crucial to have a legal environment that is conducive to good transactions among people if you are to develop a market economy. The question then is why don't we in Peru have that kind of law? People in the United States, in Western Europe, and in Japan have been able to create that kind of environment.

We asked first of all how many laws do we actually produce? The Peruvian central government produces 27,000 rules per year. That means about 111 new rules per working day. Of these 27,000 rules a year, 99 percent are produced by the executive branch and only 1 percent by Parliament. That is, only 1 percent of our rules are made in an open forum where people can discuss them or the press can cover them.

How does this figure differ from governments such as those in the United States, Switzerland, or Germany? First of all, a great amount of law in a country like the United States is produced through courts—this is the common law. Different judges with independent juries, with different prosecutors, and with different lawyers can continually examine conflicts within the land and can add to the existing jurisprudence with their decisions and debates. The thousands of courts spread around your country keep the lawmakers in touch with what people are doing. But we have no common law in Peru, like most of the Third World.

Of course, the United States does produce law in the executive branch. But this is where one of the most fascinating things starts: Your basic wealth as a nation has come from the fact that you have a rulemaking process, which keeps government more or less accountable to the people, and that your rules generally reflect what people would reasonably do anyhow as opposed to our rules. The terrible thing is not only that we don't know about your lawmaking process, but also that you don't

(Cont. on p. 8)

Cato senior fellow Peter J. Ferrara, a former official of the Department of Housing and Urban Development, talks with newly appointed HUD official Wendell Gunn.

Free Market Path (Cont. from p. 7)

know about it. We haven't found one person who can give us the whole inventory on how rules are made in the United States.

The first thing we did notice was that when your executive branch brings out rules, it has to follow a series of procedures that try to protect the people who have to abide by the rules. Second, these rules always call for comment periods or for public hearings. You also have adjudicatory processes, whereby, licenses, concessions, and rules are subject either to public scrutiny or to being challenged in court.

You have cost benefit analyses, which accompany most of your important economic regulations. Then you have access to public information. In Peru, we not only do not have access; public information is forbidden by law in most cases.

You have congressional elections in which you have continual feedback. Your people must represent a constituency or they will not be reelected. In my country that is not the way it proceeds. Nobody has to win a primary. You just try to get high up on the party's list, which depends very much on the internal party organization and not on constituencies.

You also have courts in which you have equal access to justice. Any citizen can use the courts to fight a regulation. You have institutional checks and balances such as the General Accounting Office. In some states you have referendums, and sometimes you have sunset laws.

Even the way you produce your legal codes is full of feedback. The bar associations participate in making codes. The Unified Commercial Code of the United States was actually built by the American Law Institute and the National Conference of Commissions on Uniform State Laws. After 15 years of debate, 49 states voluntarily adopted the unified code, thereby proving that the code really did reflect what people wanted.

All these examples mean that your laws and governments are structured so that it is practically impossible to create regulations that would force an entrepreneur to work for 289 days to register a business. In other words, the market does influence government in the United States. These mechanisms are not available in Latin America. Not only are they not available, whenever we call in development experts from abroad, they don't know what it is we lack. The experts know how to transfer technology and capital resources to developing countries, but they are not aware of the institutional framework. You are not very conscious of your rulemaking procedure, so it's something you can't teach; yet it's what we need the most.

Feedback and accountability seem to be the crucial elements of democracy, and the only way to create rules to allow a market economy is to create this system over many hundreds of years. As a result, the United States finds it difficult to produce a blueprint. Therefore, what we have to do at the Institute is create this blueprint of how a country can make a transition from mercantilism to a market economy.

The other day a U.S. Supreme Court Justice asked me how I expected to create a blueprint of the kind of legal environment that is needed for business in my country, when it took the United States over 250 years to build the system. That is why we are now studying Germany and Japan more closely. Both the Germans and the Japanese were able to establish the right legal environment for a market economy in their countries in just a few years.

What is needed is shock—to realize that your system did not work—and we, who have the Shining Path around our cities, know that we're in trouble. We're dividing our reforms into two chapters: One is what we call the accountable state, and the other is called the enfranchising state.

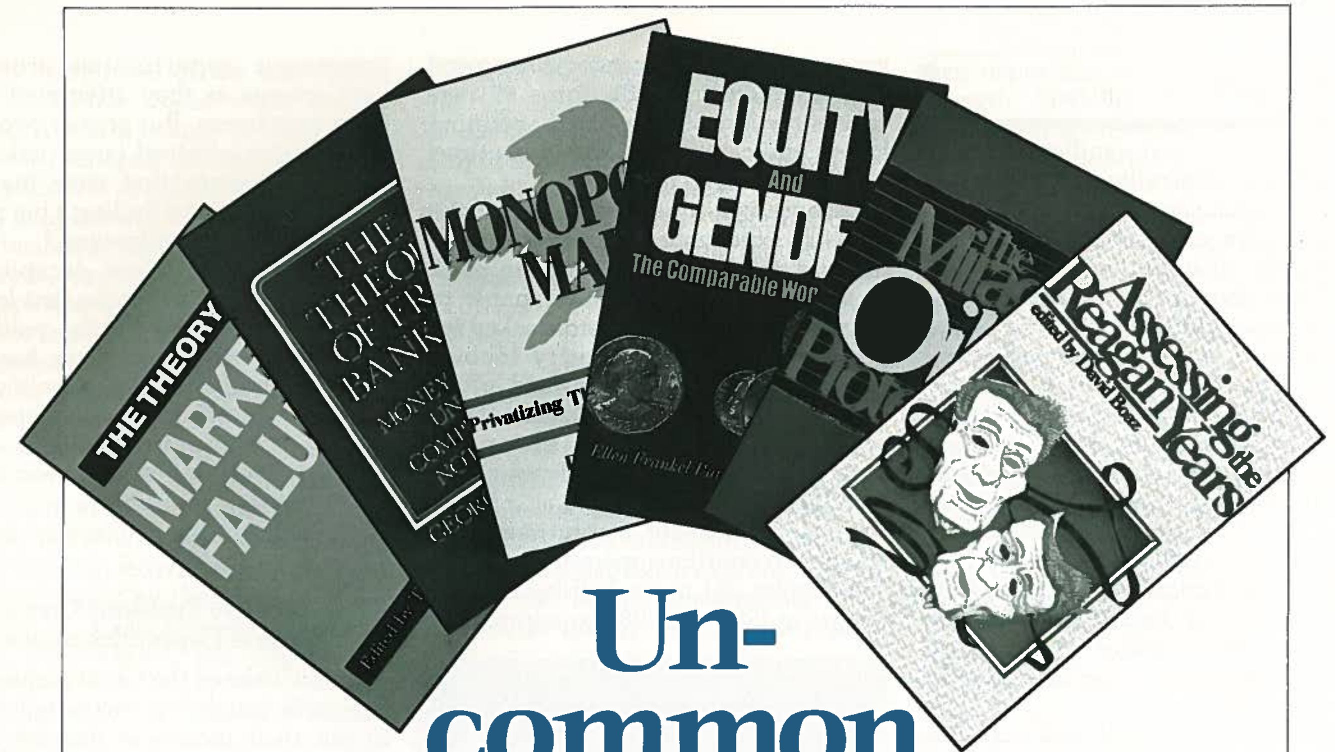
Some people say the Peruvian people are not used to democracy, but that is not true. The informal sector in Peru has its own extra-legal norms, or what we would call the common law of the informal sector. Throughout the informal sector there are democratic elections all the time. In Peru between 1968 and 1980, I was not allowed to vote because Peru was subject to a dictatorship. But during all those 12 years the informal sector was voting every 2 years.

So there is no cultural barrier to democracy in my country. What we have is an ideological barrier of people on top who say the only way to govern our indigenous class is through strong rules. We are trying to overcome this by developing our blueprint for the transition from mercantilism to democracy and economic freedom. ■

Hernando de Soto autographs his book, *The Other Path*, after his Cato Policy Forum address.

Call for Papers

The Cato Institute seeks papers on public policy issues for the *Cato Journal*, *Cato Policy Report*, and the Policy Analysis series. Send papers or proposals to Editor, Cato Institute, 224 Second Street S.E., Washington, D.C. 20003.



Un-common policy sense.

The Theory of Market Failure edited by Tyler Cowen. A dazzling collection of essays that question the "public goods" rationale for government services. Contributors include Paul A. Samuelson, Ronald H. Coase, Harold Demsetz, James M. Buchanan, and Robert W. Poole, Jr. 1988/384 pp./$21.75 cloth

The Theory of Free Banking by George A. Selgin. The first comprehensive study of unregulated banking, where banknotes are issued competitively and there is no central bank, this book demonstrates how competition will automatically keep money supply in line with demand. Throughout the book, the author uses examples from history to buttress his theoretical arguments. 1988/218 pp./$33.50 cloth

Monopoly Mail by Douglas K. Adie. This volume reviews the many failures of the U.S. Postal Service—an inability to innovate, soaring labor costs, huge deficits, chronic inefficiency, and declining service standards. The author blames most of these problems on the Postal Service's monopoly status and makes the case for deregulation, divestiture, and privatization. 1988/197 pp./$34.95 cloth/$19.95 paper

Equity and Gender by Ellen Frankel Paul. An examination of the case for and against comparable worth, which concludes that comparable worth is a backward-looking approach that will not achieve what its proponents promise. 1988/143 pp./$24.95 cloth/$12.95 paper

The Mirage of Oil Protection by Robert L. Bradley, Jr. A thorough rebuttal of the case for a tariff or quota on imported oil, along with a free-market agenda for relieving the depressed oil industry. 1988/254 pp./$23.50 cloth/$11.95 paper

Assessing the Reagan Years edited by David Boaz. Thirty-one leading policy analysts look at the successes and failures of the Reagan administration in tax policy, spending, foreign and military policy, trade, education, regulation, civil rights, entitlements, and other areas. 1988/431 pp./$29.95 cloth/$14.95 paper

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S&L Crisis (Cont. from p. 1)

regulators have been significantly more successful at controlling industry risk than have S&L supervisors.

Most news stories have focused on funding the cleanup, and the proposal does have several flaws. The administration's assumptions about the future performance of the economy and expected growth in the thrift industry undoubtedly are overly optimistic.[1] If insolvent institutions have suffered greater losses than are now recognized, if additional institutions require aid, or if the economy or the industry does not perform as well as the Bush administration's projections, the ultimate costs will climb higher than $200 billion, and taxpayers will be forced to shoulder a much larger share of the burden than currently expected.

While criticism is deserved, however, the details of funding the cleanup are not critically important. The economy has already suffered the losses and misallocations caused by the thrift industry fiasco. Consequently, even recognizing the full costs of the cleanup on-budget should have no serious implications for the broader economy, even though the reported deficit would increase.[2] The important question is how to avoid repeating the crisis.

President Bush and his advisers apparently believe that the massive thrift industry losses resulted from a failure to adequately police the industry. That conclusion is true only in a superficial sense. The shovels used by S&L managers and owners and federal authorities to dig this $200 billion hole were overregulation and federal deposit insurance.

The Victims of Government Involvement

The industry first encountered difficulties because the federal government required S&Ls to provide long-term, fixed-rate mortgages funded with short-term deposits. Then interest rates began to rise in the late 1970s. Housing sales slumped just when S&Ls needed to turn over their portfolios more rapidly. Meanwhile, savers removed their money from 5¼ percent accounts and put it in money market mutual funds. Thrift institutions found their costs rising rapidly while their income remained stagnant.[3] During 1981, some 85 percent of the industry reported operating losses, and capital at many institutions was rapidly absorbed.

Because institutions throughout the industry experienced simultaneous difficulties, the Federal Home Loan Bank Board and the FSLIC were unable to respond. While the regulators asked for more resources, the industry lobbied against additional funding and urged Congress to give undercapitalized thrifts an opportunity to outgrow their problems. Thus, capital standards were lowered, accounting trickery was encouraged, and insolvent institutions were allowed to continue operating.

Congress did make half-hearted attempts in 1980 and 1982 to address the regulation-induced problems of the thrift industry. The deregulation of interest rates paid on deposits was begun in 1980 so that S&Ls (and banks) could retain their deposit customers. In 1982 thrifts also were given broader powers enabling them to reduce their dependence on fixed-rate mortgages. Unfortunately, these deregulatory steps, though necessary, were taken without dealing with the already decapitalized institutions and, even more importantly, without addressing the incentive problems created by federal deposit insurance.

> "The shovels used by S&L managers and federal authorities to dig this $200 billion hole were overregulation and federal deposit insurance."

The Two "Levels" of Mistakes

Most analysts now recognize that forbearance (i.e., the decision to allow hundreds of S&Ls to continue operating without capital) was a serious mistake.[4] Managers and owners with none of their own funds at stake sought investment opportunities promising high returns as they attempted to recoup past losses. But greater promised returns also involved larger risks, and most institutions that were managed with an eye toward finding a big payoff suffered large losses instead.[5]

The failure to close decapitalized thrifts constitutes only the first level of mistake, however. While politically motivated forbearance now has been roundly condemned, the policy that supported forbearance has received less attention. Without federal deposit insurance, there would have been no opportunity for conditions within the thrift industry to deteriorate as they did.

The Incentive Problems Created by Federal Deposit Insurance

In the wake of the Great Depression, Congress sought to encourage people to put their money in healthy banks and leave it there.[6] The introduction of federal deposit insurance was an element in the congressional response to the economic crisis. Since their founding, the federal deposit insurance agencies have attempted to avoid even inconveniencing depositors in bankrupt institutions, much less imposing significant losses on them.

Most failures are handled through arranged mergers over weekends so that disruption is minimized. In many cases all depositors are protected, particularly when large institutions are involved. Deposit insurance also focuses on individual accounts, providing virtually unlimited coverage for depositors willing to place their funds in several institutions.[7] And if there is a delay in distributing the funds of a failed bank or thrift, the federal insurers guarantee accrued interest as well as principal.

In fact, the federal government has been too accommodating. Its policies have created an environment in which most depositors have no reason to concern themselves about the management practices or reputations of those depository managers to whom they entrust their money.

So managers of insolvent institutions, as well as those simply inclined to take more risks, easily outbid more conservative banks and S&Ls for funds. Individuals who place deposits of less than

$100,000 bear none of the risk themselves, and many focus solely on return. As a result, money is flowing to the worst-managed institutions in the country. Extensive federal deposit guarantees, coupled with the policy of capital forbearance, have acted as a magnet for frauds, just as deposit insurance has supported bad managers.[8] Without discipline from the depositors who fund these operations, the burden of supervising the practices of S&L managers falls almost entirely on federal regulators. As Gerald P. O'Driscoll, Jr., an economist with the Federal Reserve Bank of Dallas, has observed, "It is no accident that federal deposit insurance and the modern federal regulatory system were created by the same act. The incentives established by the insurance system necessitated the regulatory framework."[9]

But that brings us full circle. It was government-sponsored regulation that first led to the extensive problems of the thrift industry. Obviously, the federal government simply cannot substitute for market oversight in controlling risk.

The Failings of Government Oversight

In the first place, government-sponsored rules and regulations are by their nature inflexible. The federal government could not have anticipated the high interest rates of the late 1970s and early 1980s; even if it had, appropriate legislative and regulatory responses probably would not have survived the inevitable political challenges. Nor can new rules and guidelines be written today that foresee the economic or technological changes that will make them obsolete in the future. As a result, every regulatory scheme can carry within it the seeds of widespread industry difficulties.

Secondly, the federal regulatory agencies will never have the personnel nor the financial resources to effectively regulate a financial system as large and diverse as ours. Adequate oversight requires not only having interested parties who are in a position to monitor managerial behavior on a regular basis, but also an environment in which the attention of depository managers is focused on making decisions that emphasize financial stability and health first.

Finally, the problems created by federal deposit guarantees are just as real for banks as for thrift institutions.[10] The current system is generating instability throughout the financial structure. With the thrift industry teetering over the abyss and the banking industry on a similar path, it is time to address the problems created by federal deposit insurance.

Reforming the Federal Deposit Insurance System

To return the U.S. financial industry to long-term stability, depositor dependence on federal deposit guarantees must be reduced and eventually eliminated. When depositors can no longer rely on the federal government (i.e., their fellow taxpayers) to protect their interests in the event of a depository failure, then managers and stockholders of financial institutions will have to change the way they do business. To attract and retain accounts, bankers will need first to convince their customers of the financial health and stability of their institutions.

> "As the financial markets increase in complexity, only the market can control the risktaking of depository managers."

To signal their financial strength, successful depository institutions would hold more equity capital than many have today. Banks and S&Ls would develop more extensive secondary markets for common types of loans so they could increase the liquidity of their portfolios. In addition, portfolios would be better diversified to reduce the risk associated with overdependence on sector-specific loans. Healthy institutions would no longer seek to hide behind vague and misleading accounting rules, but would increase their use of market-value accounting to inform their depositors of continued financial strength. Stronger institutions would also encourage the development of rating services providing reliable, third-party information to potential customers about depository strength. Finally and most importantly, before making investment and lending decisions, depository managers would consider the impact of potential problems on future depositor confidence.[11]

These changes would represent a radical departure from the way business is done today at many institutions. Since 1934, the federal government gradually has assumed from bank and thrift managers more and more of the responsibility for reassuring depositors. This has freed depository managers and stockholders to pursue other goals. Increased returns and institutional growth have replaced financial strength as the primary objective of many depository decisionmakers.[12]

This shift in the focus of the deposit-taking industry is responsible for many of the problems facing the financial markets today. In addition to the speculative investments made by many thrifts, the LDC debt problem and the absence of sufficient capital at many banks, to name just two examples, can be laid largely at the door of federal deposit insurance.

The failure to understand how substantially the market would differ in the absence of federal deposit insurance is the source of many misunderstandings. Unfortunately, these misunderstandings have made their way into a report released recently by the FDIC.

In its report, *Deposit Insurance for the Nineties*, the FDIC talks about the need to develop "an appropriate balance between depositor discipline and financial stability." Later this view is made more specific when the FDIC concludes that "the trade-off between stability and depositor discipline must be weighed heavily in favor of stability."

But as explained herein, there is no tradeoff between stability and the market-sponsored discipline that would arise if explicit and implicit government guarantees were removed. In fact, quite the opposite is true. Only the market can muster the resources and create the environment that will lead managers and stockholders to pursue financial strength and stability as their

(Cont. on p. 12)

S&L Crisis (Cont. from p. 11)

first priority. As the financial markets increase in complexity and as money is transferred around the world in milliseconds, only the market can control the risktaking of depository managers.

Conclusions

The savings and loan fiasco has revealed a structural flaw in our system for supervising depository institutions. Unfortunately, most analysts and observers have misinterpreted recent events or are choosing to ignore the true source of the problem. Without federal deposit guarantees to distort the market for deposits, no amount of politically sponsored forbearance or lax supervision could have created a crisis of the current magnitude.

The existing system rewards speculative behavior at the expense of more prudent management. It has encouraged funds to run to, rather than away from, the worst-managed, most-indebted institutions in the country. And while the banking industry's regulatory structure is currently viewed as a model operation, its performance is praiseworthy only in relation to the thrift industry fiasco. Banks face similar incentives for excessive risktaking, and cracks in the bank regulatory and deposit insurance systems remain unnoticed only because attention is focused elsewhere.

Taxpayers, who will ultimately pay most of the thrift industry's cleanup costs, should receive something more for their contribution than a reshuffling of the government's organizational charts and empty promises of "tougher regulation." Taxpayers deserve substantive reforms that address existing flaws in a way that will eliminate the possibility of future crises. Federal deposit insurance is a source of disease that eventually will cause the U.S. financial system to stumble and collapse. It is time to set in motion reform of the federal deposit insurance system. It is time to begin eliminating depositors' and bankers' dependence on federal guarantees. ■

> "Taxpayers deserve substantive reforms that address existing flaws in a way that will eliminate the possibility of future crises."

Footnotes

[1]The administration assumes, for example, that Treasury rates will fall below 5 percent—a happy thought for those of us holding adjustable-rate mortgages, but one unlikely to be fulfilled. In addition, the administration projects strong growth in thrift industry deposits. But banks and thrifts generally are facing increasing competition for savers' dollars. Competing effectively for deposits will be made even more difficult for S&Ls as their costs are driven up by increased deposit insurance premiums.

[2]Indeed, recognizing the costs of the cleanup up front is in the long-term interest of taxpayers. On-budget expenditures would generate lower overall borrowing costs because the Treasury can borrow at lower rates than other government-sponsored entities. In addition, more money up front would allow federal regulators to close money-losing institutions more quickly.

[3]For an earlier description of these problems, see Joe Stilwell, "The Savings & Loan Industry: Averting Collapse," Cato Institute Policy Analysis no. 7, February 15, 1982.

[4]Forbearance can be viewed as creating incentives similar to those created by sending someone to Las Vegas with your money. If he wins, he keeps the profits and returns your investment. If he loses, you suffer the losses. Under such conditions the gambler's betting strategy probably would involve more risk than if he were required to provide the initial funds himself.

[5]It is important to recognize that large losses would have occurred even without new powers because changing market conditions had already placed the industry in jeopardy. In addition, riskier mortgage portfolios, offering larger potential returns, can also be assembled. The problems with the laws passed earlier in the decade were not the new powers they contained. The problem was the government's failure to deal with the lack of capital in the industry.

[6]During the nationwide bank holiday declared by the Roosevelt administration in March 1933, government officials examined banks throughout the country. Only demonstrably solvent institutions were allowed to reopen. This concerted effort to rid the economy of the least stable depository institutions probably did as much to restore confidence in the banking system as the delayed introduction of federal deposit insurance.

[7]In fact, bank holding companies have aided depositors who place large sums of money by distributing those funds in accounts at different banks within the same holding company.

[8]The widespread fraud in the current thrift industry fiasco would come as no surprise to students of the banking industry in the 1920s and 1930s. Many influential groups, including the American Bankers Association and most state banking organizations, opposed the introduction of federal deposit insurance precisely because it would enable fraudulent and incompetent managers to compete effectively for funds. See, for example, Helen M. Burns, *The American Banking Community and New Deal Banking Reforms, 1933-1935* (Westport, Conn.: Greenwood Press, 1974).

[9]Gerald P. O'Driscoll, Jr., "Deposit Insurance in Theory and Practice," in *The Financial Services Revolution: Policy Directions for the Future*, ed. Catherine England and Thomas Huertas (Boston: Kluwer Academic Publishers, 1988), p. 167.

[10]The banking industry does not exhibit the same symptoms of crisis as savings and loans because banking charters traditionally were less restrictive than charters granted to thrift institutions. This difference has saved banks from the kind of industry-wide crisis that engulfed S&Ls. There is substantial evidence that the banking industry is suffering serious strains, however, and its insurance fund appears healthy only in relation to the FSLIC.

[11]For a more thorough discussion of how the market would protect depositors' interests in the absence of federal deposit insurance, see Catherine England, "Agency Costs and Unregulated Banks: Could Depositors Protect Themselves?" in England and Huertas.

[12]There is nothing inherently wrong with these competing goals, of course, but their elevation in the priorities of bank and thrift managers has increased the risk embodied in depository institutions generally.

Interns Needed

The Cato Institute seeks interns for fall 1989. Please contact David Boaz at Cato for more information.

Challenge Warsaw Pact to Ban Conscription, Study Urges NATO

A ban on military conscription on both sides of the Iron Curtain would improve Western security, decrease the role of the military in the USSR, and dramatically advance the cause of international peace, according to a new Cato study.

Defense analyst Stanley Kober notes that "such a proposal would be a dramatic departure from traditional arms control measures." But he argues that the idea has the simplicity of the zero-option, which was essential to demonstrating American sincerity in the INF negotiations. It would also markedly improve conventional stability, "for can anyone imagine a major conventional war in Europe without the power to conscript?"

Kober contends that proposing to outlaw conscription would be an imaginative way for the West to regain the diplomatic initiative from the Soviets, who would be under strong pressure to accept a ban, lest they resume their unwanted former role as "the major obstacle to reducing tensions in Europe."

Noting that Soviet conscripts alone exceed total U.S. armed forces by as much as 750,000, Kober shows that troop withdrawals accomplish only part of their goal of achieving conventional force parity in Europe. "As long as the Soviets maintain conscription . . . there will be a structural limit to the extent of the USSR's demobilization."

The paper also demonstrates that a ban is viable. If it "included the dismantling of the Soviet bloc's programs of predraft training in schools and paramilitary organizations," the treaty would provide adequate warning of any danger arising from its abrogation. If either side reinstated its draft, "the lag between its introduction and any significant increase in military capability would be so great that the other side would have more than enough time" to respond.

The draft is already politically unpopular in France and West Germany, and both countries are finding it increasingly difficult to meet manpower requirements via conscription. By ending the practice, domestic political gains would accompany heightened security for Western Europe.

"To Reduce Military Tensions in Europe, Ban Conscription" is no. 116 in the Cato Institute's Policy Analysis series. It is available for $2.00. ■

Federal Reserve governor Martha Seger talks with *Cato Journal* editor James A. Dorn and Federal Reserve economist Robert Keleher at book party for *An American Vision.*

Historic Opportunity

Scholar Hails Soviet Reforms

The Soviet reform movement may create significant opportunities for the United States and its allies to improve relations with the USSR, a new study from the Cato Institute observes. However, it also warns that the West should not overestimate the scope of the movement or misunderstand its underlying rationale.

Sovietologist Thomas M. Magstadt notes that "all indications are that Gorbachev means business when he talks about economic reforms." In an exhaustive survey of the reforms, Magstadt argues that Gorbachev views a partial deregulation of cultural affairs and the encouragement of more open debate as necessary to achieve the personal popularity and "grass-roots political support he needs to sustain the [economic] restructuring." However, Gorbachev has made clear that Soviet democratization "does *not* mean a multiparty system."

Magstadt contends that the reforms have presented the United States with historic opportunities. "Having staked so much on his image, Gorbachev cannot now afford to ignore public opinion at home or abroad," Magstadt writes. "The United States should take advantage of this vulnerability."

He proposes that the United States and the Soviet Union pursue joint efforts to resolve regional conflicts in such areas as South Asia and southern Africa. Similarly, future arms control agreements should be undertaken bearing in mind "the fact that breakneck military spending is sharply at odds with Gorbachev's number one priority: economic revitalization."

In addition, the current "opportunity to reduce tensions and end [Europe's] division into rival military blocs" should not be squandered. Washington should now press plans for "the disengagement of superpower forces" across the continent and the orderly phasing out of NATO and the Warsaw Pact.

"Gorbachev and Glasnost—A New Soviet Order? Implications for U.S. Foreign Policy" is no. 117 in the Cato Institute's Policy Analysis series. It is available for $2.00. ■

Fiat Money (Cont. from p. 3)

to list all the possible forms competitive money might take . . . because the production of money is an area in which free enterprise has so long been denied."

George A. Selgin, a professor of economics at the University of Hong Kong and author of the Cato Institute book *The Theory of Free Banking*, urged that legal restrictions on bank activities—such as rules on branch banking, portfolio diversification, and mergers, along with mispriced deposit insurance—be repealed, after which central banking and fiat money could be ended.

Nobel laureate James M. Buchanan takes notes on a talk at monetary conference.

Former Reagan economic adviser Jerry L. Jordan calls for loosening government controls on money.

Other speakers included Allan Meltzer of Carnegie-Mellon University; Richard W. Rahn, vice president and chief economist at the U.S. Chamber of Commerce; the University of Georgia's Richard Timberlake; Cato chairman William A. Niskanen, also a former CEA member; and Robert L. Greenfield of Fairleigh Dickinson University. The papers from the conference will be published in an upcoming edition of the *Cato Journal*. ■

Cato Journal Looks at Trade Deficit and Exchange Rates

The latest issue of the *Cato Journal* (vol. 8, no. 2) features articles on "Dollars, Deficits, and Trade: The Changing World Economy." The issue contains essays on exchange-rate theory, trade deficits, and the international monetary system. A number of noted policymakers and scholars contribute to it, among them Federal Reserve Board vice chairman Manuel H. Johnson; former Council of Economic Advisers member Thomas Gale Moore; Anna J. Schwartz of the National Bureau of Economic Research and Michael Bordo of the University of South Carolina; and Leo Melamed, chairman of the Executive Committee of the Chicago Mercantile Exchange.

Manuel H. Johnson argues that price stability should be the primary goal of the Federal Reserve Bank. He calls for expanded use of alternative indicators in setting Fed monetary policy. Among the indicators he suggests are broad-based commodity price indices and the international financial markets.

In another article, Leo Melamed writes about the history of one such market, the International Monetary Market (IMM), the innovative financial futures market that he cofounded in the 1970s. Melamed cites the extraordinary success of the IMM as an example of the free market's superior ability to respond to the constant changes in the world economy. He notes that "the IMM made financial futures an indispensable tool of risk management. . . . We could not have prospered, nor would the world have fared as well, if the IMM had not been a necessary by-product of the same economics that ushered in the new era of flexible exchange rates."

In "The Uneasy Relation between the Budget and Trade Deficits," Cato chairman William Niskanen asserts that the trade deficit has become a problem only because it has been erroneously attributed to "unfair" practices by America's trading partners. The nation's main economic problem, he contends, is the federal budget deficit, which should be reduced through government spending restraint in such rapidly growing areas as defense, medical care, and agriculture.

Michele Fratianni, a former Italian government adviser, debates Alan Walters, a personal adviser to British prime minister Margaret Thatcher, over the effectiveness of the European Monetary System. Fratianni contends that the EMS has helped to stabilize European currency by using the strength of the German central bank to minimize the costs of disinflationary policies pursued by the weaker central banks of France and Italy. Walters counters that the EMS has politicized the exchange rate regime and made European financial stability largely dependent on German hegemony.

The *Cato Journal* is available for $7.00 an issue or $21.00 a year. ■

1989 Summer Seminar in Political Economy

Dartmouth College • July 1–8, 1989

Speakers include Charles Murray, Ralph Raico, Leonard Liggio, David Kelley, Mario J. Rizzo, Catherine England, Earl Ravenal, Ted Galen Carpenter, George H. Smith, and Edward H. Crane.

For more information, please contact Sandra McCluskey, Cato Institute, 224 Second Street S.E., Washington, D.C. 20003. (202) 546-0200. Deadline for receipt of applications is May 31.

Call Gorbachev's Bluff, Offer Peace Terms for Cold War

by Patrick J. Buchanan

NATO is on a collision course with itself. At issue: German refusal to permit the United States to upgrade the short-range Lance missile, a critical nuclear component of allied defense.

Resolution of the crisis, however, should be simple: The United States should accede to Bonn's demand, and delay a decision to deploy the Lance until the German elections, as Chancellor Kohl insists.

Why? Because the NATO crisis is not a crisis of military preparedness; it is a political crisis which will become a disaster if we force down Germany's throat an atomic weapon which is, after all, designed for Germany's defense.

In the great game for Europe, Soviet President Mikhail Gorbachev is playing a weak hand masterfully well. As he announces each unilateral tank and troop withdrawal, as he speaks of a "common European home," he massages the deep German longing for peace and reunification. All he asks in return is that Bonn not modernize the nuclear weapons on German soil, an offer Mr. Kohl cannot refuse.

Meanwhile, the German public, enamored of the new star in the East, is becoming exasperated with NATO training flights in German air space and tank maneuvers on German farmland. The makings of a disastrous breach between Washington and Bonn are present. Should Mr. Gorbachev suddenly announce he will tear down the Berlin Wall, in return for West Germany's adopting a posture of neutrality, we could have a terminal crisis in the alliance.

The United States needs to escape from the arms control box, with its minutiae and arcana, where U.S. weapons that defend Europe are put on a par with Russian weapons that threaten Europe, and deal ourselves into the political game, where we hold the high trumps.

Let us call Mr. Gorbachev's bluff, and expose his strategy for NATO's rupture, and Soviet hegemony in Europe, by offering Moscow terms of peace for ending the Cold War.

If Moscow will take down the Berlin Wall, and withdraw from East Germany, Czechoslovakia, Hungary and Poland, we will bring our troops home to the United States, all of them. To demonstrate U.S. sincerity, President George Bush might unilaterally withdraw 1,000 nuclear warheads, and one U.S. Army division.

With an offer of U.S.-Soviet disengagement in Central Europe, the ball will be back in Mr. Gorbachev's court. It will be clear to West Germany that its ally, the United States, supports fully the desire of all the German people for reunification. It will become clear to Europe and the world that Washington has no secret agenda for a permanent military presence on the continent, that we have no investment in permanent Cold War. Our vital interests can be fully met, if the Soviets and we both go home; and the nations of Europe are free to determine their own destiny. As Mr. Gorbachev holds out the appearance of ending the Cold War in Europe, let us trump his ace, and offer Europe the reality, by 1992.

Should Moscow accept, it would mean a reduction of $100 billion in the U.S. defense budget, and an end to the danger of U.S.-Soviet confrontation in Europe. Free Europe, for which we have sacrificed for 40 years, would become reality. The Cold War will have ended on terms far more favorable to freedom and the United States than did World War II. Easing Moscow's fears, Russia would face West toward a peaceful, Finlandized Central Europe, and an America with her armies, air force and atomic weapons off the European continent.

Should Moscow spurn the offer, West Germany and the world will know who truly seeks imperial advantage in a divided Germany and a divided Europe.

The historic risk, of course, is that, if America goes home, Moscow might lunge back into Central Europe. But, before reaching Berlin a second time, the Red Army would have to fight its way into Poland and Germany, destroy all her diplomatic and economic ties in Europe, and run the risk of retaliation from France, Britain and the United States. Moreover, the world would finally wake up.

This proposal (cogently advanced by Christopher Layne in the new Cato publication *An American Vision*), or something equally bold, seems essential. Europeans are fed up with U.S. "dictation"; Americans are fed up with allies who carp, freeload and traffic with an enemy against whom we defend them at inordinate cost and risk to ourselves. But peevishness should not be a basis for policy.

If the U.S. response to each Gorbachev gambit is manfully to urge NATO to stay alert, and insist that the Germans accept new nuclear weapons, we will soon be out of the game, and out of Europe, with nothing to show for it. Given German attitudes, the Lance missile will not be upgraded. Given American attitudes and U.S. budget constraints, cuts in U.S. troop strength seem inevitable. Let us make a virtue of necessity; let us offer to take not one division, but all our divisions home, if Mr. Gorbachev will take all his divisions back to Mother Russia, leaving Poles, Czechs, Hungarians and, yes, the German people free at last to determine their own future.

We are told Mr. Gorbachev is a new kind of Communist, who seeks an end to the Cold War, but who is frustrated by Cold Warriors in the West, particularly right-wingers in the United States. Well, let us test that proposition, and offer him honorable peace terms in the Cold War. If he takes us up on it, it is time to come home. ■

Patrick J. Buchanan is a nationally syndicated columnist. This column appeared recently in the *Washington Times*, the *New York Post*, and other newspapers. Reprinted by permission of Tribune Media Services.

"To be governed..."

"Reagan Slashes Budget for Last Time"

When President Reagan submits the final budget of his Presidency Monday, it will be the first in which both Government spending and Government revenues exceed $1 trillion, which is roughly twice the size of the budget Congress enacted in Mr. Reagan's first year in office, 1981.

—*New York Times*, Jan. 8, 1989

Newspeak

Japan plans to announce this week that it will extend its quotas on automobile exports. . . .

In a strictly legal sense the quotas are voluntary, imposed by the Japanese government on its own manufacturers.

—*Washington Post*, Jan. 10, 1989

The rest of you can wait your turn

The regional postmaster who ordered a ceiling on the Washington area's postal work force was asked yesterday to submit his resignation. . . .

[Johnny F.] Thomas' departure was seen by some people who follow Postal Service operations as a strong indication that Postmaster [General Anthony M.] Frank has taken a personal interest in turning around poor service in the Washington area.

—*Washington Post*, Jan. 31, 1989

And you thought they just kept AIDS cures off the market

The surest sign that white chocolate has arrived is the steady supply on supermarket shelves. . . . But shoppers searching for it will find it only under an alias.

Because there are no cocoa solids in white chocolate, the Food and Drug Administration forbids manufacturers to use the word chocolate to describe their product, which is made of cocoa butter, milk solids and flavoring.

—*New York Times*, Dec. 21, 1988

U.S. Postal Service: You have made the right choice

"Aeroflot Airlines: You Have Made the Right Choice" [is the] theme of the new Soviet ad campaign for the USSR's only airline.

—*Newsweek*, Jan. 16, 1989

And who wants people like that?

Immigration officials are planning an aggressive program to deport illegal aliens who cannot prove they would be persecuted in their Central American homelands. . . .

Most "tell us they are here because they want to improve their standard of living," said [Immigration and Naturalization Service] spokeswoman Virginia Kice.

—United Press International, Dec. 14, 1988

The Reagan Revolution: federalism and deregulation

The Department of Transportation yesterday rejected a controversial plan by Massachusetts officials to reduce traffic at Boston's busy Logan Airport by raising the cost of using the airport for small private planes.

—*Washington Post*, Dec. 23, 1988

The Federal Trade Commission yesterday charged six major book publishers with illegally discriminating against independent bookstores by selling books at lower prices to major bookstore chains.

—*Washington Post*, Dec. 23, 1988

Stop me before I legislate again

Anti-fax legislation introduced in Connecticut by Rep. Richard Tulisano asks a $200 fine for sending unsolicited material by fax.

—*Wall Street Journal*, Jan. 26, 1989

Deregulation, Reagan style

The Agriculture Department temporarily has relaxed the minimum size requirements for shipments of Florida Dancy tangerines.

From Nov. 21 through next Aug. 20, citrus growers may ship tangerines that are 2¼ inches or larger in diameter. Before, the smallest tangerine had to be at least 2⅜ inches.

—*Washington Post*, Dec. 21, 1988

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