

## Would More Regulation Prevent Another Black Monday?

by Joseph A. Grundfest

On October 19, 1987, the U.S. stock market suffered the greatest single-day decline in its history; the Dow Jones Industrial Average fell 508 points. A similar fate befell many of the world's other financial markets as well. As a result, October 19 has come to be known far and wide as "Black Monday."

As might be expected, the events of Black Monday have spawned thousands of pages of postmortem analysis. Government agencies and market experts have weighed in with different views of what happened, why it happened, and how likely it is to happen again. In particular, many members of the federal regulatory agencies with jurisdiction over the U.S. financial markets seem to

Joseph A. Grundfest is a member of the Securities and Exchange Commission. The views expressed in this article do not necessarily reflect the views of other commissioners or the commission's staff. This article is excerpted from a talk he delivered at a Cato Policy Forum in July.

have concluded that these financial markets are in desperate need of a "magic bullet" to prevent such precipitous drops in the future and that such a remedy can be found in a massive dose of new regulation.

In my view, however, more regulation is not the "magic bullet" that will prevent a recurrence of Black Monday, particularly if that regulation interferes significantly with the operation of the market. As I see it, the events of Black Monday were caused by the interaction of two distinct sets of factors. The first set of factors relate to fundamental changes in investors' perceptions of equilibrium prices in the world's capital markets. The second set relate to flaws in the regulatory and institutional superstructures that influence price-setting in the capital markets. Regulatory agencies may be able to solve problems caused by regulatory and institutional structures, but they are as powerless as King Canute when they seek to override fundamental changes in investor

### In This Issue

Reagan Revolution book	3
Cato events	4
Does the World Bank help the Third World?	6
Haste and waste in defense spending	13
New book warns of oil protectionism	14
Cato study criticizes gun control	14
Buchanan and Miller in <i>Cato Journal</i>	15
Comparable worth treats women as victims	15

expectations.

Indeed, when regulators attempt to prevent markets from adjusting to fundamental economic events and changes, they are certain to do far more mischief than good. In fact, I believe that the medical aphorism *Primum non nocere*—First, do no harm—should be tattooed inside the eyelids of all government regulators to keep us from falling prey to the false but comforting notion that our intervention can countermand fundamental market forces. Regulatory hubris can be a dangerous disease.

Once one appreciates the inherent limits to regulatory intervention, it becomes important to determine which aspects of the market's behavior on Black Monday are attributable to imperfections in the regulatory and institutional environment as distinguished from changes in investor expectations. It is both feasible and legitimate for SEC regulators to head off precipitous declines in the equities, options, and futures markets by taking steps to eliminate such imperfections. Evidence of such



Cato president Edward H. Crane, *Losing Ground* author Charles Murray, and Judge Douglas Ginsburg of the U.S. Court of Appeals for the District of Columbia Circuit at a recent Cato luncheon.

## The Candidates' Risks and Opportunities

### Chairman's Message



For those of us who are more concerned with the substantive outcomes in American politics than the partisan ones, the presidential campaign of 1988 has been exceedingly depressing. From listening to either George Bush or Michael Dukakis, one might think that increasing the supply of child care and reducing the supply of drugs were the most important next steps toward a more perfect Union. It would behoove each candidate to convey some recognition of the opportunities and risks that he would encounter as president and to explain how he would address them.

A major opportunity for a Bush administration would be to consolidate and develop the Reagan economic program. Above all, that would require a steady reduction of the still-huge federal deficit without a reversal of the two most significant achievements of Reaganomics: the substantial decreases in tax rates and inflation. So far, Bush's only proposals for reducing the deficit have been a "flexible freeze" and a line-item veto, but they are only instruments of policy; he has not identified the specific program changes that would be needed to sustain such a freeze or the types of spending that he would veto. The prime targets for spending restraint by a Bush administration, I suggest, are the programs for which outlays during the Reagan years increased the most: defense, health care, and agriculture. A Bush administration should also implement the complementary measures that are needed to sustain deregulation, especially that of the airlines and financial institutions.

A second major opportunity for a Bush administration would be to sort out America's relations with the Soviet Union, an endeavor in which the Republicans would have a unique advantage. Something important is happening in the Soviet Union, but Gorbachev's objectives, his relative authority, and the probable length of his tenure are not yet clear. Capitalizing on that opportunity would require the courage to promote changes that would serve both U.S. and Soviet interests—and therefore the wisdom to recognize which changes would not serve U.S. interests.

The main risk for a Bush administration would be a stalemate. A president who was elected by a small margin without having discussed the nation's most pressing problems would have no mandate to resolve them, and a Bush administration would probably have to face a Democratic Congress that would create new problems. Bush can still avoid a stalemate, but time is running out. He and his cam-

paign advisers should remember the lesson of 1980: Reagan beat both Bush and Carter by outlining a comprehensive agenda that addressed the major problems of that year.

The main opportunity for a Dukakis administration would be to implement reforms that the Reagan administration did not implement and a Bush administration probably could not, including overhauls of social security and the complex web of health, safety, and environmental regulations. The Harvard crowd understands how serious the problems arising from those programs have become, and only the Democrats would be likely to have a political mandate to address them.

I sense that Dukakis would not be a big spender, despite his record as governor of Massachusetts. The large federal deficit and the voters' strong aversion to a tax increase will constrain the spending advocates in both parties.

The main risk for a Dukakis administration would be the temptation to broaden the welfare state by requiring employers to provide pensions, medical insurance, child care, maternity leave, severance pay, and other benefits. In all likelihood, mandated benefits would be more costly than programs financed through the federal budget. Moreover, because such benefits would not be subject to periodic reviews in the budget process, the costs would be less apparent and the distribution of the costs would be more arbitrary. Democrats who point out that European governments have already adopted a number of mandated benefits should recognize that the extremely slow growth of employment in Europe is largely a result of those measures. Unfortunately, the Democrats apparently regard the risk of damaging America's economy by following suit as their main opportunity.

As has been the case in most presidential campaigns, neither candidate has said very much about his conception of the role of the federal government. Dukakis's assertion that "competence, not ideology" is the central issue in 1988 is misguided. Both Bush and Dukakis are intelligent and hard working, and both have demonstrated competence in several areas. The central issue in any presidential campaign is what the federal government should do and, even more important, not do. The two candidates should say far more about that issue—both to provide the voters with a better basis for making their choice and to increase the prospect that the winning candidate will have a sufficient mandate to govern.

*William A. Niskanen*

—William A. Niskanen

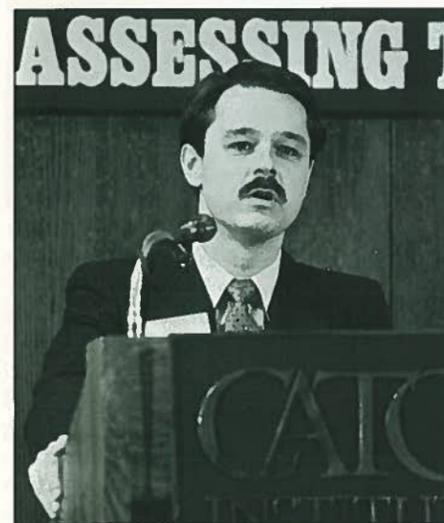
### 31 Perspectives

## Cato Book Asks, Was There a Reagan Revolution?

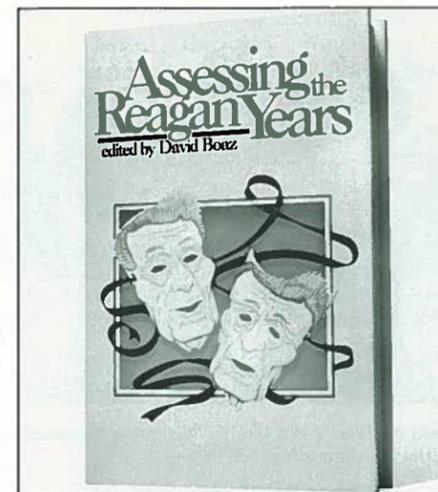
Was there a Reagan Revolution? In *Assessing the Reagan Years*, a new book published by the Cato Institute, 31 distinguished policymakers, scholars, and policy analysts examine the administration's record on a wide spectrum of issues and offer provocative answers to that question.

The contributors evaluate the administration's performance in such areas as taxing and spending, foreign relations and defense, money and banking, welfare and transfer payments, law and the courts, and domestic policy. The book concludes with a section on the Reagan legacy that features essays by Cato president Edward H. Crane, *Forbes* deputy editor-in-chief Malcolm S. Forbes, Jr., and Paul Weaver, author of *The Suicidal Corporation*.

The editor of the collection, Cato vice president David Boaz, writes in the introduction, "No president in this century has come to Washington with



David Boaz



a clearer policy agenda than Ronald Reagan, or so the story goes. The months between his election and his inauguration were marked by manifestations of terror on the part of the Washington establishment. . . . The critics needn't have worried. As the months wore on, it became evident that the dreaded Reagan reform crusade would amount to business as usual."

In an essay on the administration's trade record, former Council of Economic Advisers chairman Murray L. Weidenbaum asserts, "It is clear that the United States has become more protectionist since Ronald Reagan moved into the Oval Office. By 1985, the Reagan administration had openly adopted the 'fair trade' term that traditionally has been the protectionists' euphemism for trade restrictions. . . . [But] the administration's move toward protectionism has been much less rapid than would have been the case if the administration had merely followed the lead of Congress. In comparison to

your favorite senator, every member of the Reagan cabinet is a paragon of free trade."

Cato chairman William A. Niskanen joins Weidenbaum in noting that the administration has failed to combat the Washington status quo effectively. In a chapter on Reaganomics, Niskanen observes that "there are very few consistent advocates of spending restraint in the administration or in either party in Congress. Almost every self-styled fiscal conservative strongly supports some part of what [David] Stockman called the 'social pork barrel.'"

In his contribution to the volume, *Forbes* argues that although the Reagan administration has been "weak on attacking mercantilism and beggar-thy-neighbor policies," it has succeeded in many other areas, most notably taxation. He predicts that "when historians look back on the period, they will conclude that the nation's economy and political system had once again confounded the critics, the skeptics, and the crepe-hangers."

In the book's final essay, Crane writes, "The politicians ultimately intimidated Ronald Reagan and his advisers. It didn't have to be that way. . . . It would be wrong for supporters of limited government to throw up their hands in dismay and say, 'If Reagan couldn't do it, nobody can.' It definitely won't be easy, but somebody can. Somebody must. The American experiment in limited government and individual liberty is too important to leave in the hands of those not totally committed to preserving it."

*Assessing the Reagan Years* is available from the Cato Institute, in paper for \$14.95 and in cloth for \$29.95. ■

Published by the Cato Institute, *Cato Policy Report* is a bimonthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems. It also provides news about the activities of the Cato Institute and its adjunct scholars. *Cato Policy Report* is indexed in *PAIS Bulletin*.

Correspondence should be addressed to: *Cato Policy Report*, 224 Second Street S.E., Washington, D.C. 20003. *Cato Policy Report* is sent to all contributors to the Cato Institute. Single issues are \$2.00 a copy.

ISSN: 0743-605X

Copyright ©1988 by the Cato Institute

David Boaz . . . . . Editor  
David Lampo . . . . . Managing Editor  
Gordon Anderson . . . . . Assistant Editor

#### Cato Institute

William A. Niskanen . . . . .	Chairman
Edward H. Crane . . . . .	President
David Boaz . . . . .	Vice President, Public Policy Affairs
Catherine S. Smith . . . . .	V.P., Development and Public Affairs
James Bovard . . . . .	Associate Policy Analyst
Ted Galen Carpenter . . . . .	Director, Foreign Policy Studies
James A. Dorn . . . . .	Editor, <i>Cato Journal</i>
Catherine England . . . . .	Director, Regulatory Studies
David Lampo . . . . .	Publications Director
Sandra H. McCluskey . . . . .	Director of Public Affairs
James M. Buchanan . . . . .	Distinguished Senior Fellow
F. A. Hayek . . . . .	Distinguished Senior Fellow
Doug Bandow . . . . .	Senior Fellow
Earl C. Ravenal . . . . .	Senior Fellow

## Summer Activities Include Forums, Intern Lectures

### Cato Events

**June 1: "U.S. Policy toward Western Europe after the INF Treaty."** Cato adjunct scholar Christopher Layne discussed the possible effects of the INF treaty on the NATO alliance. Having noted that the treaty has triggered a long-overdue reexamination of the alliance, he called for the United States to launch a diplomatic offensive designed to achieve a mutual superpower military disengagement from central Europe. Commenting on Layne's speech was Kim Holmes, deputy director of defense policy studies at the Heritage Foundation.

**June 14: "The Case for Free Trade."** In the first of a summer series of lectures for Washington interns, cosponsored by the Cato Institute and the Institute for Humane Studies, IHS public affairs director Sheldon Richman described the economic and social benefits that free trade provides.

**June 15:** Cato chairman William A. Niskanen discussed the topic of his latest book, *Reaganomics: An Insider's Account of the Policies and the People* (Oxford University Press, 1988), at a luncheon attended by journalists from the *New York Times*, the *Washington Post*, the *Wall Street Journal*, and other newspapers. Drawing on his experiences as a member of President Reagan's first-term Council of Economic Advis-



Cato chairman William A. Niskanen discusses his book *Reaganomics* at a luncheon for members of the Washington press corps.

ers, Niskanen recounted the decisions and events that shaped the administration's economic program, then assessed its likely impact.

**June 15: "Does the World Bank Help the Third World?"** Nick Eberstadt, a visiting scholar at the American Enterprise Institute, and Melanie Tammen, a research associate at the Heritage Foundation, criticized the World Bank's lending record. They argued that because the bank's loans have consistently promoted wasteful, money-losing public works projects and severe human rights abuses, its funding should not be increased.

**June 28: "The New Right v. the Constitution."** In the second summer intern lecture, Cato adjunct scholar Randy

Barnett, a professor at the Illinois Institute of Technology, Chicago-Kent College of Law, asserted that constitutional interpretation by the courts should involve a "principled judicial activism" that would protect both economic and civil liberties. Barnett maintained that conservatives' judicial restraint doctrine is as much at odds with the Founders' views as liberals' "living Constitution" theory.

**July 3-10:** Seventy-five people participated in Cato's 10th annual **Summer Seminar in Political Economy**, held at Dartmouth College. Lecturers included welfare critic Charles Murray, Austrian-school economist Israel Kirzner, Cato senior fellow Earl Ravenal, French economist Henri Lepage, and Cato Fellow in Social Thought Ralph Raico.

**July 11: Congressional Briefing on Aviation Safety.** Six experts, including Clifford Winston of the Brookings Institution and Michael Levine of Yale University, discussed the findings of a recent report by the Aviation Safety Commission during a half-day seminar in the Dirksen Senate Office Building. Among the panelists' objections to the commission's report was that it failed to address the aviation industry's infrastructure problems. The commission's proposal to convert the Federal Aviation Administration into a government corporation along the lines of the Postal Service was also criticized by some of the panelists.



Cato director of foreign policy studies Ted Galen Carpenter and Bida Mwale of Zambia talk at Cato's 10th annual Summer Seminar in Political Economy.

**July 12: "The Case for Strategic Independence."** Ted Galen Carpenter, Cato's director of foreign policy studies, delivered the third summer intern lecture to a standing-room-only crowd. Carpenter discussed the need to abandon the doctrines of collective security and extended deterrence, which have guided America's foreign policy since World War II, and adopt a hemisphere-oriented defense strategy based on vital U.S. interests.

**July 14: "Beyond the French Elections to 1992: Prospects for Free-Market Developments in France."** Henri Lepage, a

**July 19: "Racism, Sexism, and the Free Market."** George Mason University economist Jennifer Roback gave the fourth summer intern lecture, discussing the historical evidence that a number of government regulations—particularly laws that restricted the economic transactions of minorities and women—have fostered racism and sexism. She argued that a free market creates incentives to abandon biased attitudes and behavior.

**July 21: "Would More Regulation Prevent Another Black Monday?"** Joseph Grundfest, a member of the Securities and Exchange Commission, addressed

more than 70 people in a talk on the implications of last October's stock market crash. Grundfest argued that imposing strict regulatory constraints on such innovations as futures and options trading exacerbated the market's decline. He warned that regulators can prevent another Black Monday only by adopting policies that improve market information and increase market capacity and liquidity.

**July 26: "Beyond Good Intentions: A Biblical View of Politics."** Cato senior fellow Doug Bandow spoke on the theme of a new study, published by Crossway Books, in which he considers the nature of the political guidance that the Bible provides. He maintained that the Bible does not prescribe a specific political agenda and that religious activists ought to be skeptical about the wisdom of turning to government to promote their views.

**July 27: "Ending the New Prohibition: The Case for Drug Legalization."** In the fifth summer intern lecture, Cato vice president David Boaz argued that the failure of a war on drugs is inevitable and that the illegality of drugs not only violates civil liberties but exacerbates the problems it is intended to solve. He contended that legalization would reduce violent crime dramatically, get drugs out of school yards, and eliminate a major source of corruption and waste. ■



West German economist Joachim Scheide discusses the performance of the Deutsche Bundesbank during the 1980s as William A. Niskanen and others listen.

research associate at the Centre de l'Entreprise in Paris, discussed the political and economic implications of France's recent elections. He noted that policy changes made by Socialist president François Mitterrand, such as promoting privatization and less government intervention in the economy, may be indicative of a shift in national attitudes toward business and politics.

**July 14: "Monetary Policy in West Germany."** Joachim Scheide, a research fellow at the Kiel Institute of World Economics, discussed the performance of the Deutsche Bundesbank during the 1980s. He contended that the effectiveness of a monetary target rule has not been discredited by recent German experience and that if the central bank had followed a stable targeting policy, the country's economy would have benefited.



Clifford Winston, a senior fellow at the Brookings Institution, discusses airline safety as Competitive Enterprise Institute president Fred Smith listens.

## Does the World Bank Help the Third World?

### 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 Nicholas Eberstadt, a visiting scholar at the American Enterprise Institute, a visiting fellow at the Harvard Center for Population Studies, and author of *Foreign Aid and American Purpose*, and Melanie Tammen, a research associate at the Heritage Foundation's Center for International Economic Growth.

**Nicholas Eberstadt:** The World Bank today is very different from the institution envisioned, and brought to life, at the Bretton Woods conference in 1944. To understand what has happened to the bank, it is necessary to review some history.

The Bretton Woods institutions—the World Bank and the International Monetary Fund—were created near the end of World War II, principally through American and British efforts, to address what were anticipated to be some of the most serious economic problems of the postwar world. Much of Europe and Asia lay devastated; rebuilding those regions after the Allied victory and restoring commercial and industrial activities in liberated areas to their prewar levels appeared to be an enormous and formidable task. The architects at Bretton Woods were also cognizant of the risk that a breakdown in the international trading system would provoke a protracted international depression, as it had in the interwar period. At the very least, it seemed to them, something would have to be done to secure the process of currency convertibility so that international trading partners need not fear reimbursement in, or the accumulation of, foreign money.

The International Monetary Fund was meant to deal with the latter set of concerns. Its particular answer to the question of convertibility was to ar-

range for a system of pegged exchange rates that could be adjusted through international consultations and that would ultimately be backed by gold reserves in the new lending authority. The World Bank, for its part, was meant to be very much what its formal title suggests—that is, an International Bank for Reconstruction and Development. The bank was intended to help ensure international flows of investment capital to regions in which, by dint of uncertainties attendant upon war or decolonization, business confidence might be unnaturally and unreasonably low.

There is another sense in which the function of the World Bank was ex-



Nicholas Eberstadt: "By the early 1980s many of the recipients of World Bank loans were openly declaring their inability to honor the schedules for repayment."

pected to conform to its title. It is clear that its founders intended the World Bank to be just that—a bank. The organization was meant to lend money for profit and to base its lending decisions on criteria of creditworthiness. Indeed, the first president of the World Bank resigned precisely because he was not confident that the institution would be able to operate as a bank; he did not see how it would be able to borrow enough money to cover the loans it would have to dispense.

In the 1940s and the 1950s the World Bank paid attention to concepts that are no longer current in "development lending." Some of the terms by which the bank set its institutional sights have an unfamiliar, even antique, ring these days. Take "business climate," a phrase

that seems to have utterly disappeared from the bank's lexicon. In the 1940s and the 1950s it was taken for granted that the bank would consider lending to countries that were judged to have an auspicious environment for business and investment but would refrain from lending to countries whose business climate was chilly—no matter how poor or otherwise deserving such countries might have been.

The bank even had a policy, in those days, known as "strategic nonlending." Countries that might have qualified for the World Bank's publicly guaranteed loans on strict criteria of creditworthiness were more than once denied such funds through strategic nonlending. The idea was that the World Bank simply would not participate in a loan if a country's practices or policies were degrading its investment climate or otherwise moving its economy in an untoward direction.

In its early decades, the bank grew and prospered as a profit-seeking entity. The rules and precepts by which it operated appear to have had much to do with that success. But in the 1960s and the 1970s the bank's operations, its understanding of its mandate, and its prospects for long-term solvency veered sharply away from the path of its initial years.

One could say that the bank and the IMF were victims of their own success. By the 1960s, after all, the problems with which the Bretton Woods institutions had been established to assist were no longer really problems. The international trading system seemed secure and vibrant; the convertibility of the major currencies was not much of a worry. A few years later, in fact, the Smithsonian arrangements were to usher in an era of floating exchange rates—a regimen that, on its face, would seem to address all the arguments through which the IMF was initially justified. As for the World Bank, by the 1960s war-ravaged Europe and Asia were not only rebuilt but prospering. International capital markets were dynamic and deepening, certainly capable of allocating investment funds to any corner of the earth. (The trillion-dollar "Third World debt crisis" about which

we hear so much today may attest to many things, but an insufficient flow of capital to low-income regions in the postwar period would not seem to be one of them.)

The bank's response to the change in the international situation was to change the definition of its own task. The transformation began in the very early 1960s, but it accelerated radically with the presidency of Robert McNamara, who moved to the bank from the Defense Department shortly after the Tet offensive in 1968.

McNamara oversaw a more than tenfold increase in nominal commitments by the bank during his tenure in office. One might say that he globalized the economic model that had been developed in Vietnam in the mid-1960s. One of the objectives of U.S. policy in Vietnam was to decouple the living standards of local populations from the production levels in the same localities. The idea was to ensure the material well-being (and thereby to cement the loyalty) of groups that would otherwise be forced to rely for their sustenance on production capacities that had been decimated by the vicissitudes of war. Similarly, after McNamara's appointment to the World Bank the institution strove to separate the living standards of recipient countries' populations from the production bases that would ordinarily be expected to sustain them. Such a policy may be justifiable when the objective is military, but as a purely economic measure, it suggests a course at best unwise, at worst positively perilous.

Yet the bank implemented that change in its policy without hesitation. It was clearly articulated through a change in the bank's lending criteria. By 1970 the bank's official position was that any project that might encourage "development" in a recipient country was worthy of consideration. Now, "development" is a conveniently elastic word; like "democracy," "freedom," and "progress," it can be used to mean many different things. Research initiated during the 1950s and the 1960s, for example, seemed to indicate that improvements in education, nutrition, and other facets of what is now called "human capital" could increase economic output. The World Bank came to argue that such findings justified its lending

to underwrite social services and social spending in low-income countries. The bank's lending committee seemed to forget what had been almost painfully obvious barely a decade earlier: that human capital would be no more capable of drawing high rates of return than physical capital if the business climate was inauspicious.

Even as the bank was relaxing its lending standards, it was adjusting its criteria for evaluating loan performance. By 1970 the World Bank's position was that any policy or project suitable for its new International Development Association subsidiary would be appropriate for the bank as well. The problem with that line of reasoning is that the IDA had been designed as a concessionary vehicle; it was ex-



Melanie Tammen: "The World Bank's policy loans are foisting a whole new debt bomb on the Third World."

pected to lose money, and its loans were, as one observer noted, "of doubtful validity by any measured banking standard." McNamara's singular success in expanding World Bank lending seems to have been accomplished primarily by making loans that previous bank presidents would have rejected as risky, frivolous, or positively injurious.

Reviewing the economic history of the 1970s would take us far afield. Suffice it to say that by the early 1980s many of the states that were recipients of World Bank loans—including many of the most frequent and enthusiastic recipients—were openly declaring their inability to honor the schedules for the repayment of public and private funds for which they had contracted internationally. There is a long and compli-

cated explanation for that phenomenon; it involves shocks to the international economy, changes in relative prices and exchange rates, and shifts in the ratios of debt service payments to export earnings. There is also a somewhat simpler explanation: loans become difficult to repay when they are used for unproductive purposes.

Obviously, the World Bank was not the only institution to dispense loans in the 1970s that appeared highly questionable in the 1980s, but it may have been the largest and the most aggressive in the pursuit of such lending. The bank came to establish itself as a very peculiar sort of lender of last resort. The use of such a large pool of capital in such a fashion naturally had consequences for international lending as a whole. Although the impact would be difficult to quantify, there can be little doubt that the bank's new posture served to degrade the quality of private, commercial lending. It may also have served to discourage direct private foreign investment in low-income countries.

A decade ago the World Bank embarked upon a wholly new form of lending whose vehicles came to be known as "structural adjustment loans" or "policy-reform loans." The ostensible purpose of such loans is to help a recipient country endure the economic pain of a transition to a responsible policy regimen. In practice, one of their virtues is that they serve as a rapid injection of funds into a recipient country's treasury. Perhaps not surprisingly, their popularity among recipient governments is now high—indeed, they may be most popular among countries that have evidenced cash-flow difficulties in meeting current debt obligations.

One may raise a variety of objections to the World Bank's newest form of lending, which in only a few years has come to account for about one-fourth of the bank's lending activity. For one thing, it is by no means clear that such lending—inasmuch as it is totally unrelated to specific projects—has any basis in the bank's Articles of Agreement. No less important, there is a problem with the entire conceptual structure underlying policy-reform loans: it is impossible to prove that such a loan has failed. Now, a project loan can always, in principle, be shown

### World Bank (Cont. from p. 7)

to have failed; a dam may not have been built, for example, or built on budget. By contrast, if a policy-reform loan is followed by an improvement in the recipient country's economic circumstances, salutary properties can be ascribed to the loan. On the other hand, if economic difficulties intensify after a policy-reform loan, the lender can always say that the situation would have been even worse if such a loan had not been made. The problem is that if it is impossible to demonstrate that a loan is a failure, it conversely is impossible to demonstrate that a loan is a success.

The World Bank is currently requesting a major increase in capital from its member states—\$75 billion, of which about one-fifth is to be supplied by the U.S. government. That request does not attest to the bank's soundness and strength. Instead, it is a powerful testament to the unsustainability of the policies that the bank has pursued over the past two decades—and the unsustainability of the policies that it has encouraged or subsidized in poor countries. Through its call for aid, the World Bank has inadvertently emphasized that it is not a self-financing entity. Lord Keynes's suggestion at the Bretton Woods conference that "the Bank should be called the Fund" was meant to be a joke. That joke, however, has come full circle.

**Melanie Tammen:** What's been disappointing to me in taking a closer look at the World Bank's policy loans—structural adjustment loans and the more narrowly focused sector adjustment loans—is the discrepancy between the professed purposes of such loans and the uses to which they have actually been put.

Policy lending has been stepped up since 1980 and particularly since 1985, when then-treasury secretary James Baker launched his reform plan in Seoul. The "Baker Plan" called for more loans to the 15 most heavily indebted countries for such reforms as privatizing public enterprises, adopting growth-oriented tax policies, liberalizing trade, and improving the environment for both direct foreign investment and domestic investment. But despite those

lofty goals, policy loans have frequently been used to fine-tune state-owned agencies and industries. The concept of privatizing loss-making or bankrupt state-owned enterprises has largely been forsaken. Moreover, a large percentage of the World Bank's funds is flowing right back to Western commercial banks as debt service, and all the while huge new obligations are being racked up by the debtor countries.

The inherent failing of the World Bank's new loans, policy loans, is the same as that of its stock in trade, project loans: they go to governments. Ironically, the very money-losing public enterprises that the World Bank ostensibly wants to remove from the government sector were created through World Bank financing in the first place. For decades the bank channeled tens of billions of dollars into state-owned enterprises in electricity, coal, steel, oil, gas, and transportation. The latest government role that the World Bank has been funding all over the globe is in telecommunications.

What about development in Africa, which is a consuming topic these days? Well, a 1981 World Bank analysis concluded that much of the bank's investment in African agriculture had gone into state-owned farms, big irrigation projects, and other capital-intensive ventures. But they have since turned out to have been largely a waste of money; their impact on output has been negligible in most cases.

For example, the World Bank invested \$29 million in an irrigation project in Kenya, but when the country's president, Daniel arap Moi, toured the site in 1986, he found eroded canals, abandoned plots, stunted crops, tumble-down and unsanitary housing, and zebras grazing on the irrigated land. A World Bank evaluation the previous year had found that severe malnutrition was widespread among the "beneficiaries" of the irrigation project, that they had mortality and disease rates several times higher than Kenya's national average, and that fully one-fifth of them had deserted their plots—despite an investment of \$50,000 per family. In the course of touring the site of that disaster, President Moi pointed out that the real losers would be future generations of Kenyans, who would have to go on paying the interest and the prin-

cipal on the World Bank's loans.

In addition, a lot of the World Bank's funds have been used to set up or reorganize state-monopoly marketing boards, which are increasingly viewed as having been responsible for stifling the production of both food crops and export crops in Africa. They are the mechanisms through which African governments have for years forced farmers to sell their crops to the state—at prices that have frequently amounted to only 50 percent of the market worth of those crops. The World Bank financed many of the agricultural communes in Tanzania, and \$260 million went to about a dozen agricultural marketing boards there. Last year a World Bank analysis concluded that except for the zero-interest IDA loans, Tanzania would have been better off if it had not borrowed at all.

There is certainly no lack of damning evidence concerning the record of marketing boards and other state-owned enterprises all over the world; the intellectual work at the World Bank and the International Monetary Fund has been very thorough. Many of you are familiar with the 1981 "Berg Report," in which the bank laid much out in the sun about the failure of such enterprises in African agriculture. And a 1984 IMF study found that in 34 less-developed countries, the net budgetary payments to state-owned enterprises averaged 3.3 percent of GDP in the 1970s. That burden represented 75 percent of the budget deficits in those countries.

It's hardly surprising that when the Baker Plan was embraced by the bureaucrats at the World Bank, the conversion to market-oriented reforms was only a partial one. Moreover, the bank's officials remain committed to the notion that incentives to maximize efficiency can be created under any type of ownership. The dominant emphasis of World Bank loans involving state-owned enterprises is still rehabilitation, not privatization or liquidation. That objective has been the focus of many of the sector loans as well as some of the freestanding technical assistance loans. (In fact, the bank's latest brand of policy loan is the "public enterprise loan.")

In recent years the World Bank has begun to realize how destructive the

African marketing boards have been. But instead of making the liquidation of those boards a prerequisite for its loans, the bank has been telling African governments, "Just pay your farmers a little bit more, lay off a little labor, and make the boards more efficient." Accordingly, policy loans have been used to pay off the arrears of several marketing boards in the Ivory Coast and to cover the "development expenditures" of Senegal's marketing boards.

Yet it is in fact possible to liquidate such boards. Nigeria liquidated its cocoa marketing board with three months' notice to the employees, and private-sector expertise filled the void quite easily. Within a year the problems with the quality of cocoa exports had been eliminated.

So although the World Bank claims to be championing privatization, at critical junctures it is in fact bailing out and entrenching state-owned enterprises all over the globe. In 1986 an internal review of the bank's policy loans, which rated the performance of the first structural adjustment loans as being quite poor in general, found that the loans for the rehabilitation of state-owned enterprises fared the worst. It was difficult to get the debtor governments to implement even the most simple reforms, such as introducing management audits and streamlining accounting procedures. Despite that record, just last March the World Bank approved a \$400 million policy loan to retool Mexico's state steel sector, which is a failing industry. Where's the reform? Well, the Mexican government is supposed to phase out the industry's subsidies in the future.

Then there is the question of whether such a large policy-based lending program is necessary. The bank claims that policy lending constitutes no more than 25 percent of its activity, but in many countries the percentage is much higher than that. In recent years policy loans have accounted for 31 percent of the World Bank's loans to Korea, 32 percent of its loans to Thailand, 41 percent of its loans to Turkey, 61 percent of its loans to Chile, and 97 percent of its loans to Costa Rica. It's not clear why Korea and Thailand, in particular, needed so much policy adjustment assistance. As for Mexico, Argentina,

and Brazil—the Latin megadebtors—they each received an unprecedented \$500 million policy loan during the past year. Brazil's loan was for agricultural reform and the other two countries' loans were for trade reform.

Such loans are supposedly used in large part to finance imports, but in fact they provide nothing more than general budgetary support. And though all money is fungible, that non-project-related assistance, based solely on promises of reform, is highly fungible. Indeed, the amount of a policy loan is determined solely by the size of the debtor country's financing gap. Thus, it's not difficult to recognize that much of the money is flowing back to the commercial banks as debt service—which has been widely acknowledged on both sides of the aisle on Capitol Hill.

So the World Bank has moved in to fill the void left by the commercial banks, which have not come through on carrying out their part of the Baker Plan, except, perhaps, in the case of Mexico. In recent testimony on the Hill, Baker has repeatedly boasted that the World Bank committed a total of \$4 billion to Mexico, Argentina, and Brazil last year alone. Pumping out those highly fungible policy loans to the 15 Baker countries is certain to downgrade the World Bank's credit rating as the years go by and the bank concentrates its portfolio more heavily in those countries. Already 10 countries account for 58 percent of the bank's portfolio: Brazil, India, Mexico, Indonesia, Tur-

key, Korea, Colombia, Yugoslavia, the Philippines, and Thailand.

Brazil alone has accounted for 15 percent of the World Bank's new lending during the past five years. Last year the Brazilian finance minister made it clear that Brazil would stay current on servicing its World Bank loans only as long as disbursements on new loans exceeded debt service on the old ones.

Finally, in the course of assessing the World Bank's newfound passion for policy-based lending, I'd like to look at its experience with its main initiative of the 1970s. In 1974 Robert McNamara, then the bank's president, who had realized that the potential of small-holder agriculture had been overlooked, launched a major program of rural development lending. During the next decade the World Bank pumped \$5.5 billion into African agriculture, which was an eightfold lending increase. Last year the bank evaluated that massive effort. According to an internal document, among the conclusions drawn were the following:

Especially in sub-Saharan Africa, rural development lending was supply-driven by funds and project slots and the need to meet arbitrary target criteria, rather than demand-driven by sound strategies and realistic, well-prepared project proposals. Moreover . . . the Bank apparently lost sight of the reality that the cost of failures . . . would be borne by the borrower

(Cont. on p. 13)



Securities and Exchange Commission member Joseph A. Grundfest discusses regulatory reform with a guest at a recent Cato Policy Forum.

**Black Monday** (Cont. from p. 1)

imperfections abounds. None of our markets covered themselves with glory on October 19, and many market systems buckled under the weight of massive information failures that were due, in part, to the substantial peak load. Those information failures exacerbated the illiquidity that can accompany a rapidly moving, high-volume market and contributed volatility that could have been avoided.

Although it is impossible to ascertain precisely how much of Black Monday's 508-point decline is attributable to fundamental factors and how much is attributable to flaws in the regulatory and institutional structure, I estimate that between 200 and 250 Dow points of the decline could have been avoided through a regulatory policy that improved information flows, increased market capacity, and enhanced market liquidity.

In making this distinction between fundamental economic factors and regulatory and institutional imperfections, it is absolutely essential to reject the Luddite conception of our capital markets as computer-driven automatons. Program trading, index arbitrage, futures trading, options trading, and several other useful market innovations have been incorrectly blamed for Black Monday's events. These innovations were not the cause of the market break; they were instead the mechanisms for the market's decline. Nonetheless, some participants in the policy debate have a perfectly rational incentive to continue to condemn the messenger instead of the message and to forestall further technological progress, which would threaten traditional trading mechanisms that generate substantial rents for certain traders. To put it more bluntly, some people are making money off the present system, and measures designed to make the markets more efficient by improving information flows, increasing capacity, and enhancing liquidity are not in their best interest.

**The Macroeconomic Environment**

Perhaps the most interesting development in the policy debate is a consensus that the sharp decline in equity values on Black Monday was triggered by

changes in the macroeconomic environment that induced dramatic changes in investor expectations. In a recent address at a conference sponsored by the *Financial Times*, Consuela M. Washington, counsel to the House Energy and Commerce Committee, pointed out that such an explanation has been advanced by the Brady Commission, the SEC staff report, the Commodity Futures Trading Commission, the chairman of the Federal Reserve Board, and several market observers with widely differing vantage points on the events of October 19, including Felix Rohatyn of La-

**"Certain policy-makers and market participants distrust innovations such as futures and options trading, index arbitrage, and program trading. Their solution is to turn back the hands of time."**

zard Freres and Franklin Edwards of Columbia University.<sup>1</sup> Among the most frequently mentioned macroeconomic culprits are adverse interest and exchange rate developments, an antitakeover tax proposal adopted by the House Ways and Means Committee, and continuing bad news about the U.S. trade deficit.

Many foreigners appear to have a different perspective, and in discussions with leaders of other countries' banking and business communities, I have heard views on the origins of Black Monday that are not often expressed in the U.S. policy debate. Many of them perceive October 1987 as a dangerous period in which major governments attempted to maintain interest and exchange rates at levels that were at odds with both internal economic developments and changing macroeconomic conditions. In the

presence of semipegged interest and exchange rates, the equity markets turned out to be the principal equilibrating force through which capital markets could express themselves. Thus, the depth of the equity markets' decline may have been increased by efforts to prevent necessary price movements in foreign exchange and government debt markets.

Findings by Richard Roll of UCLA are generally consistent with that internationalist account.<sup>2</sup> Professor Roll notes that all 23 of the world's major capital markets declined sharply on or around October 19. Of those 23 markets, the U.S. market registered the fifth-smallest decline—or, to put it another way, the fifth-best performance. Furthermore, Professor Roll claims that the U.S. market was not the first to fall; the decline apparently originated in the non-Japanese Asian markets on October 19, their time, and then followed the sun to Europe, the Americas, and Japan. Moreover, Professor Roll finds no link between computer-directed trading and the extent of the U.S. market's decline. He concludes that "the global nature of the October crash seems to suggest the presence of some underlying cause, but it debunks the notion that some basic institutional defect in the U.S. was the cause, and it also seems inconsistent with a U.S.-specific macroeconomic event."

The foreign business leaders with whom I spoke also seemed a bit amused by the enormous U.S. preoccupation with analyzing and reanalyzing the events of Black Monday. With the exception of the Hong Kong market, which shut down for the week of October 19 and suffered a serious setback because of both that shutdown and the many flaws in its internal processes, no market in the world has occasioned as much second-guessing and finger-pointing by its observers and participants. Although I firmly believe that our broad and searching investigations of the crash have been helpful, I was quite intrigued by the suggestion that we have been overdoing it with our studies, commissions, task forces, reports, and recommendations. Foreigners, even those whose markets experienced larger equity declines than that of the United States, appear much more inclined to conclude that the events of October 19

were a reaction to adverse international macroeconomic developments and that little is to be gained from microeconomic tinkering with the markets.

**Regulatory Flaws**

Nevertheless, the flaws in the regulatory and institutional environment that contributed to the U.S. market's decline on Black Monday can and should be corrected. These imperfections include information failures, capacity constraints, and liquidity traps. These factors are interrelated, and they compounded each other during the market break to make a bad day worse.

In a nutshell, during October 19 there were substantial periods when traders did not have access to accurate information about the current prices of trades they were considering and the status and execution prices of orders that they had already entered. That problem was created not only by the speed with which the market was moving but by capacity constraints in the equity markets. As a result, traders were being asked to "trade blind," and it is no surprise that they either backed away from the market or demanded premiums for the risk of trading subject to such uncertainty. In short, information failures caused liquidity to be removed from the market at precisely the time when liquidity was needed most.

The information failures grew worse on October 20, when traders' confidence in the solvency of some major market participants began to wane. Traders' concern was generated by delays that futures clearinghouses experienced in making substantial payments to large investment banks. Again, because traders perceived that doing business with investment banks and clearinghouses involved a credit risk, they backed away from the market at a time when liquidity was badly needed. All of the institutions in question were in fact solvent, but that information could not be signaled promptly or credibly. Thus, the information failure relating to credit status increased illiquidity in the market even further.

In addition, a relatively unknown regulatory constraint in the form of position limits on index options may have exacerbated the information failures that contributed to Black Monday. Index options can constitute an alterna-

tive to the traditional vehicles through which traders practice dynamic hedging techniques: portfolio insurance and stop-loss orders.

Investors who purchase portfolio insurance are generally seeking to shift the risk that a market index will fall in excess of some predetermined amount. They attempt to prevent such losses by practicing dynamic hedging techniques such as selling into declining markets and buying into rising markets.

Ironically, purchasing portfolio insurance, which is often reviled as the demon that spooked the market into a

**"Regulators can help avert another Black Monday primarily by improving information flows, increasing market capacity, and enhancing market liquidity."**

crash, is basically no different from stop-loss selling, which is often heralded as a conservative strategy suitable for small investors who wish to minimize their risk. Thus, as Robert Shiller of Yale University has pointed out, even if no formal portfolio insurance programs had existed on Black Monday, the market might have been susceptible to "profit-taking" through stop-loss orders.<sup>3</sup>

For example, suppose that a trader with a \$3 million portfolio invested in the equity market when the Dow is at 2500 wants to ensure that he will be out of the market when the Dow hits 2200. He can practice a dynamic hedge that consists of selling \$1 million worth of stock when the Dow hits 2400, another \$1 million when the Dow hits 2300, and the last \$1 million when the Dow hits 2200. By following that simple set of stop-loss rules, he can "insure" himself against losses resulting from the market's dropping below

2200—provided, of course, that the market does not gap downward or become so illiquid that he can't execute his trades close to the required prices, which is the fate that befell many traders on October 19.

But there is a market substitute for the use of portfolio insurance or a stop-loss order as a dynamic hedge: the purchase of a put option on a portfolio. I would argue that, given sufficiently well informed market participants, the price of a dynamic hedge will, at the margin, equal the price of an equivalent put.

There is, however, an important difference between insuring a portfolio through dynamic hedging techniques and insuring a portfolio through the use of put-option transactions. As Sanford Grossman of Princeton University pointed out in a prescient August 1987 article, dynamic hedging techniques convey far less information to the market than equivalent put-option transactions.<sup>4</sup> When an investor buys a put option, he is signaling to other market participants that he wishes to shift his downside risk; the premium he pays for the put option is the price that the market demands for the opportunity to shift that risk. In contrast, dynamic hedging strategies are not made public until they are implemented during a market decline, nor are their prices estimable in advance. Thus, it can be argued that on Black Monday the market would have been less susceptible to destabilizing price shocks, some of which resulted from the unexpected use of stop-loss orders and portfolio insurance, had more investors relied on put-option transactions rather than on dynamic hedges.

Institutional investors, however, have essentially been prevented from making effective use of put options because SEC-approved exchange regulations limit the amount of such "insurance" that they can obtain.<sup>5</sup> As one commentator put it, "Unless and until position limits are eliminated, the [Standard & Poor's] 500 Index option cannot rival the S&P 500 futures contract for portfolio insurance business."<sup>6</sup> Thus, options position limits may have had the unfortunate side effect of forcing much risk-shifting activity away from the options market, which would have provided traders with more information about

(Cont. on p. 12)

**Black Monday** (Cont. from p. 11)

the demand for downside equity-risk hedges on Black Monday, and toward dynamic hedging techniques, which are more secretive.

**Turning Back the Clock**

Not everyone agrees that the proper response to the events of October 19 consists of improving information flows, increasing market capacity, and enhancing market liquidity. Certain policymakers and market participants distrust innovations such as futures and options trading, index arbitrage, and program trading. Their solution is to turn back the hands of time and reestablish an environment in which the prevailing ethos is that stocks are bought and sold one at a time and trading decisions are based on fundamental assessments of each issuer's underlying prospects.

I doubt that our equity markets ever truly worked that way, but even if they did, there is no legitimate reason to try to turn back decades of progress. In the past 20 years the theory and practice of finance have undergone a revolution as profound as those in bioengineering, superconductivity, and other areas of high technology. We now know that because portfolios have properties that are different from the properties of their constituent securities, it often makes perfect sense to trade securities as portfolios (or baskets) rather than as individual securities.

Moreover, today's institutional investors are so large that it is often impractical for them to make investment decisions on a stock-by-stock basis. Institutional investors generally cannot maximize their returns by picking General Motors over General Dynamics or General Electric or by engaging in other "stock picking" efforts. Instead, large investors must seek their gains through shrewd allocations among equities, long bonds, short bonds, real estate, venture capital, and other broad investment classes. Thus, many institutions have no rational choice but to trade portfolios as portfolios.

Those two forces—the emergence of information indicating that it is often smart to trade portfolios as portfolios and the prevalence of large institutions

that are obliged to trade portfolios as portfolios—have combined to increase the demand for portfolio-related transactions services in the equity market. Unfortunately, the supply of portfolio-related transactions services has not kept pace with demand. In particular, the New York Stock Exchange does not yet provide explicit basket-trading services and still requires that equities be traded on a stock-by-stock basis.

To get an inkling of the magnitude of the problem, consider the following analogy. If a trader wants to sell a basket of stocks in today's equity market, the basket will be broken down into, say, 400 individual stocks, and the sale will require 400 transactions on the floor of the exchange. Anyone who wants to

**"The medical aphorism *Primum non nocere*—First, do no harm—should be tattooed inside the eyelids of all government regulators."**

buy exactly the same basket will also have to engage in 400 transactions on the floor of the exchange. If we operated our used Volkswagen market that way, each seller would drive his VW onto a dealer's lot, where it would be stripped down to fenders, doors, engine block, and so on. When a buyer walked onto the lot, the dealer would reassemble the VW.

Now, if that doesn't seem like a particularly wise way to buy and sell VWs, I suggest that it also isn't a particularly wise way to buy and sell baskets of equities. Recent developments, however, suggest that the New York Stock Exchange is actively exploring basket trading mechanisms, and I hope we will soon see substantial progress in that direction.

**Conclusion**

Regulators can help avert another

Black Monday primarily by improving information flows, increasing capacity, and enhancing liquidity. If the demand for portfolio-related transactions services continues to increase rapidly and regulators fail to innovate vigorously, they will run a substantial risk of damaging the nation's financial services industry. Critics who urge regulators to adopt measures that would return the market to the "good old days" should realize that those days, if in fact they ever existed, were not necessarily good or fair for all traders.

More to the point, nostalgia for the past is not a viable solution to the problems that surfaced on Black Monday. The answer lies instead in regulatory and institutional reforms that enable the U.S. capital markets to adapt to changing patterns of demand. If regulators implement such procompetitive innovations, regulation has a chance of preventing another Black Monday. But if regulators attempt to forestall further progress or use the regulatory mechanism to keep markets from adjusting to fundamental changes, regulation is more likely to exacerbate the next crash, whenever it happens and however it unfolds. ■

**Footnotes**

<sup>1</sup>Consuela M. Washington, "The Crash of October 1987—A Washington Assessment of Its Significance," paper presented at the *Financial Times* conference "Black Monday—Nine Months After," July 6, 1988.

<sup>2</sup>Richard Roll, "The International Crash of October 1987," in *Black Monday and the Future of Financial Markets* (Dow Jones-Irwin, forthcoming).

<sup>3</sup>Robert Shiller, "Portfolio Insurance and Other Investor Fashions as Factors in the 1987 Stock Market Crash," February 25, 1988 (unpublished paper).

<sup>4</sup>Sanford Grossman, "An Analysis of the Implications for Stock and Futures Price Volatility of Program Trading and Dynamic Hedging Strategies," National Bureau of Economic Research Working Paper no. 2,337, August 1987.

<sup>5</sup>See, e.g., Chicago Board Options Exchange, Options Clearing Corporation, Rule 24.4 (Position Limits), January 29, 1988.

<sup>6</sup>G. L. Gastineau, *The Options Manual*, 3d ed. (1988), p. 308; Accord, J. G. Cox and M. Rubinstein, *Options Markets* (1985), p. 98.

**World Bank** (Cont. from p. 9)

countries and not the Bank. . . .

[The World Bank's] program divisions were usually allocated country lending quotas, not only in terms of funds but also in numbers of projects to be financed in a given year. These two quotas determine the potential average loan size even before the requirements of individual projects are known.

So what about the bank's main initiative of the 1980s, policy-based lending? Well, the same 1987 report admitted that "the burden of the resource transfer objective has passed to [the policy-based] structural adjustment and sector loans." And the bank's 1986 review of its first structural adjustment loans found that the preparation of new loans frequently took precedence over the supervision of old loans. There seems to be a pattern here.

The World Bank's policy loans are foisting a whole new debt bomb on the Third World. Turkey has received eight policy loans since 1980—and has increased its indebtedness to the bank by \$2.5 billion in so doing. Jamaica has also received eight policy loans since 1980. Ghana has received six loans and Zambia has received four. The Ivory Coast, a beacon of free enterprise in Africa, needed three policy loans, two of which were for \$250 million apiece.

It's important to remember that such loans are not giveaways. The debtor countries have to repay them—or at least they're supposed to have to repay them. Those ballooning obligations will be serviced with wealth produced by Third World peoples and expropriated by their governments in one way or another—perhaps through yet another increase in the marketing margins on crops or in other kinds of taxes. Maybe governments will have to resort to the outright nationalization of property.

Underlying all of the new World Bank loans aimed at fine-tuning state-owned enterprises, of course, is one fatally flawed assumption: that if bureaucracies are bailed out, they'll get it right the next time. Well, we all know that when that fails to happen, it is the Third World peoples that will be made to pay once again. ■

**Waste in Reagan Pentagon**

The record increase in peacetime defense outlays during the last decade took place without a comprehensive evaluation of national security objectives, and the money was spent "with great haste and . . . considerable waste," charges a new Cato Institute study.

Cato chairman William A. Niskanen, a former member of President Reagan's Council of Economic Advisers, writes, "According to the Constitution, the single most important role of the federal government is to 'provide for the common defense.' The large increase in real defense spending that began in 1979 did not contribute much toward the achievement of that goal."

Between 1978 and 1987 real defense outlays increased by about \$110 billion. Niskanen observes that defense spending is now about 60 percent higher (adjusted for inflation) than it was in 1978 and about 20 percent higher than it was in 1968, the peak spending year of the Vietnam War.

According to Niskanen, that increase

in spending was approved before the preparation of a defense plan consistent with real budget authority, and the Department of Defense continues to base its defense priorities on unrealistic budget projections. Its defense program for FY 1989–92 is based on a projected budget almost \$282 billion higher than the amount that Secretary of Defense Frank Carlucci optimistically predicted will be authorized.

"Congress will not sustain an increase in real defense budget authority in the absence of a war," Niskanen writes. "National security objectives must ultimately conform to what the nation is prepared to support." He concludes that without a fundamental reorientation of strategic priorities, the efficiency and effectiveness of the nation's defense system cannot be increased.

"More Defense Spending for Smaller Forces: What Hath DoD Wrought?" is no. 110 in the Cato Institute's Policy Analysis series and is available from the Institute for \$2.00. ■

# Assessing the Reagan Years

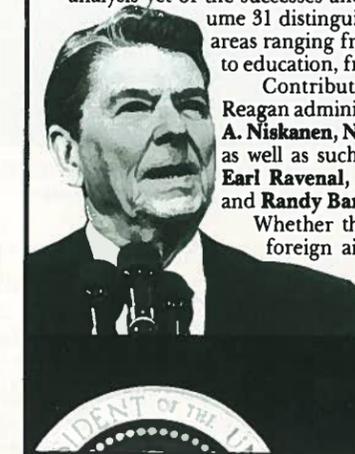
edited by David Boaz

## Was there a Reagan Revolution? If so, is it over?

Or did it have lasting effects? *Assessing the Reagan Years* is the most comprehensive analysis yet of the successes and failures of the Reagan administration. In this volume 31 distinguished analysts look at the administration's policies in areas ranging from the deficit to civil rights, from military spending to education, from the environment to taxes.

Contributors include such current or former high-ranking Reagan administration officials as Murray L. Weidenbaum, William A. Niskanen, Norman B. Ture, Clarence Thomas, and William Poole as well as such independent observers as Malcolm S. Forbes, Jr., Earl Ravenel, Paul Weaver, Edward H. Crane, Robert Crandall, and Randy Barnett.

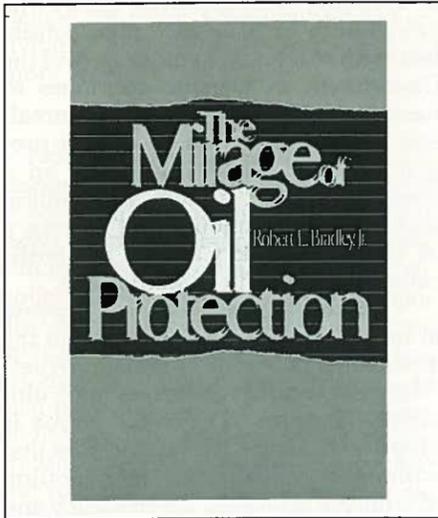
Whether the subject is trade, the Supreme Court, regulation, foreign aid, or monetary policy, the authors in *Assessing the Reagan Years* are knowledgeable, insightful, and provocative. \$29.95 cloth/\$14.95 paper/431 pp.



Available at bookstores or from:  
Cato Institute  
224 Second Street, S.E.  
Washington, D.C. 20003  
**CATO INSTITUTE**

'Deserves to Be Widely Read'

## Oil Protectionism Would Hurt Consumers and Industry



Imposing an oil import fee or enacting other protectionist legislation would fail to remedy the oil industry's depressed profits and would harm not only consumers but its intended beneficiaries, according to *The Mirage of Oil Protection*, a new book copublished

by the Cato Institute and University Press of America.

The author, industry analyst Robert L. Bradley, Jr., contends that the calls for protectionist tariffs by many U.S. oil producers are wrong-headed. Artificially driving up the price of oil in the United States would lead not to sustained relief but to political and economic struggles for the firms in an overbuilt domestic industry. Bradley delineates a program of market-oriented reforms in the areas of taxation and regulation and argues that only such a program would enable the industry to recover from its wounds.

The book begins with a comprehensive historical analysis in which Bradley examines both the roots and the effects of the current crisis in the oil industry, which has been beset by price levels lower than many companies' production costs since 1986. Bradley then assesses industry and academic rationales for protection, including the national security, conservation, and "op-

timal social cost" arguments. He finds that in each instance the costs of protection far outweigh any benefits; moreover, many of the alleged benefits are illusory. The book concludes with proposals for achieving free international trade in oil and a description of its advantages for both the industry and the nation.

Gottfried Haberler of the American Enterprise Institute called Bradley's book "a thorough and comprehensive analysis of a very important problem. . . . It is lucidly written and well organized, describes the historical background and structure of the industry, and presents all relevant statistics." M. A. Adelman of the Massachusetts Institute of Technology wrote, "*The Mirage of Oil Protection* deserves to be widely read and probably will be, no matter which party takes the White House in 1988."

*The Mirage of Oil Protection* is available from the Cato Institute, in paper for \$11.95 and in cloth for \$23.50. ■

## Handgun Ban Won't Work, Violates Constitution

A national ban on handgun ownership would infringe on the constitutional right to defend one's person and property and would fail to reduce gun-related crime, a new Cato Institute study warns.

Former Manhattan prosecutor David B. Kopel writes that "if 90 percent of American handguns disappeared, there would still be 40 left for every handgun criminal." In addition, 84 percent of handgun homicides "occur in circumstances where a long gun could easily be substituted."

Kopel also argues that the cost of such a law would be astronomical; it would create almost \$10 billion in arrest and prosecution expenses as well as require at least a 10 percent increase in the nation's prison capacity.

Ninety-seven percent of the respondents to a recent survey of police officials believe that "a firearms ownership ban would not reduce crime or keep criminals from using guns," Kopel



David B. Kopel testifies before Congress on the findings of his Cato study on gun control.

notes, and 90 percent believe that "if firearms ownership was banned, ordinary citizens would be more likely to be targets of armed violence." He also notes that in the first full year of a New York law that established mandatory sentencing for possession of an unregistered gun, handgun homicides

rose by 25 percent and handgun robberies by 56 percent.

"Gun registration is essentially useless in crime detection," Kopel writes. "Tracing the history of a recovered firearm generally leads to the discovery that it was stolen from its legal owner and that its subsequent pattern of ownership is unknown." Moreover, "statistical evidence shows no correlation between waiting periods and homicide rates."

Syndicated columnist Carl Rowan, a longtime gun-control advocate, used an unregistered handgun to defend his home against intruders just as Kopel's study was released, prompting the *Wall Street Journal* to publish an op-ed article, "Rowan Case and the Need to Bear Arms," based on the findings of the study.

Kopel's study, "Trust the People: The Case against Gun Control," is no. 109 in the Cato Institute's Policy Analysis series. It is available for \$2.00. ■

'Backward Looking'

## Ellen Paul Raps Comparable Worth

### Buchanan, Miller in Cato Journal

The latest issue of the *Cato Journal* (vol. 8, no. 1) contains articles by Nobel laureate James M. Buchanan, Office of Management and Budget director James C. Miller III, and other noted scholars and policy analysts.

In his contribution to the *Journal*, Buchanan, a Distinguished Senior Fellow at the Cato Institute, argues that so-called market failures cannot be corrected through political manipulation of the market. In fact, the market process should not be judged to have failed in the event that its participants do not attain an arbitrarily defined ideal level of output.

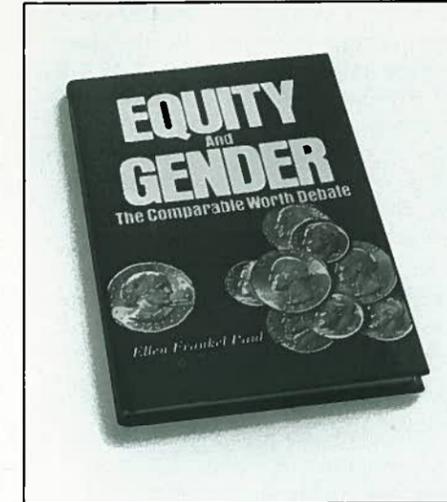
Miller calls for the privatization of the U.S. Postal Service and an end to its monopoly over first-class mail delivery. He writes, "The fundamental arguments for and against ending the postal monopoly have not changed in a century and a half. But by this time the accumulated evidence is conclusive: the privatizers and anti-monopolists have won the debate hands down. . . . We can now assert with confidence that the public has everything to gain from competition and little, if anything, to lose."

In another *Journal* article, Clemson economists William A. Kelly, Jr., Clark Nardinelli, and Myles S. Wallace argue that the government should sell the Federal Reserve and let the market determine the correct "monetary policy."

This issue of the *Journal* also contains articles on such diverse topics as artists' rights legislation, ideology and political/economic institutions, and entrepreneurship in India. In addition, it features a dialogue between Leland B. Yeager and Axel Leijonhufvud on interpreting the work of John Maynard Keynes.

In other news, *Cato Journal* editor James A. Dorn announced that Marilyn R. Flowers has joined the editorial board of the *Journal*. Flowers is an associate professor of economics at the University of Oklahoma and vice president of the Southern Economics Association.

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



Equal pay for jobs of comparable worth is a backward approach that treats women as helpless victims, according to a new volume published by Transaction Books for the Cato Institute. In *Equity and Gender: The Comparable Worth Debate*, Ellen Frankel Paul argues that equality of opportunity is a better means of promoting women's rights and economic advancement.

Paul examines the legal, economic, and moral implications of comparable worth. She agrees with advocates of comparable worth that justice must outweigh economic efficiency in considerations of the issue, but she asserts that the market process is more just than any attempt to establish salary equity by government writ.

According to Paul, assistant director of the Social Philosophy and Policy Center at Bowling Green State University, "Comparable worth . . . harps on perceived injustices of the past—some real, some exaggerated, and some simply misdirected—and pleads for redress. . . . The time has passed for women to plead with men for a fair

chance in the marketplace; they have the chance, and they should be encouraged to continue taking advantage of it. The choice seems obvious: regress with comparable worth, or progress with the market."

Praise for the book has come from many quarters. Secretary of Labor Ann



Ellen Frankel Paul

McLaughlin observed that Paul "has made a clear, compelling case against comparable worth and has done it with fairness to the views on both sides of the debate. Her presentation of the comparable worth proposals was exceptionally lucid." David Kirp, coauthor of *Gender Justice*, wrote, "*Equity and Gender* is that rarity, a thoughtful and reasoned treatment of a vexed and vexing subject. . . . Those engaged in the comparable worth debate will find both useful information and analyses that can challenge their preconceptions."

As Rita Ricardo-Campbell of the Hoover Institution observed, "Anyone who really wants to understand the pros and cons of 'comparable worth' should read *Equity and Gender*." The book is available from the Cato Institute, in paper for \$12.95 and in cloth for \$24.95. ■

### Governing Banking's Future: Markets vs. Regulation

A Cato Institute Conference  
Washington, D.C. November 2, 1988

Three subjects crucial to the future of banking regulation will be considered at this conference: payments system risk, the insulation of banks from nonbank parents and affiliates, and the growing push for international regulation of banks. Speakers will include Wayne Angell, Edward Kane, P. Michael Laub, and Gerald O'Driscoll, Jr.

For more information, contact Catherine England, Director of Regulatory Studies, Cato Institute, 224 Second St. S.E., Washington, D.C. 20003.

# "To be governed..."

## Leprechauns, we hope

[Gov. Michael] Dukakis has . . . left unstated how costly or expansive the programs could become.

A related idea advanced by Dukakis is to use groups in American society other than individual taxpayers to bear the costs of his goals.

—*Washington Post*, July 3, 1988

## It worked

[South Carolina weekly newspaper editor Jim Fitts] was particularly severe in his treatment of two legislators. . . . He claims that [they] run the county as an old-fashioned political machine. . . .

The 62-year-old Mr. Fitts, who is black, was jailed for two days last month and has been indicted on the charge of criminal libel. . . .

[Wallace] Connor, the attorney representing the legislators, says, "I can sue somebody for a million dollars, but if they don't have five cents, I'm wasting my time." The reason for filing the criminal suit against Mr. Fitts, he says, "was not so much to punish him as [to create] a deterrent." . . .

At the counter of Bea's Snack Shop, a woman asked about the case declines to give her name. "There's a lot of things going on here," she says, "but I'm not going to talk about them because I don't want to end up like Jim Fitts."

—*Wall Street Journal*, June 29, 1988

## Migrating to exploitation

Union leaders say that like the mining industry as a whole, Anglo American continues to exploit the vast pool of cheap labor available from South Africa's 85 percent black majority and the thousands of black migrants who come from neighboring African states.

—*Washington Post*, June 19, 1988

## Democracy in action

After almost 18 years in office, Representative Robert A. Roe, Democrat of New Jersey, knows only too well what the summer of an election year is like: Money has to be raised, the press needs to be prodded, advertisements must be prepared. . . .

But not this year. For Mr. Roe has no opponent.

"Oh, I'm campaigning just the same," he said. "But certainly the approach is more relaxed when there's nobody running against you."

—*New York Times*, July 9, 1988

## He means Dukakis, not Reagan

"He's trumpeting himself as the big budget balancer and here he is with a huge budget deficit," charges Edward Rogers, a senior Bush campaign aide. "It shows that he's a spender, a traditional big-government, tax-and-spend liberal."

—*Wall Street Journal*, June 16, 1988

## Democracy in action (cont.)

State Senate President Kevin Harrington worked out a strategy to get the [1976 Dukakis budget, which contained a tax increase] through: He would get all the Democrats to agree to a voice vote and, no matter what the yeas and nays would seem to indicate, he would rule that the measure carried, a tactic that would allow every member to claim he or she would have voted "No" if a recorded vote had been taken.

—*Washington Post*, July 10, 1988

## Making the world safe for oil

In the period from July 22, 1986, through July 14, 1987, before the Navy started escorting 11 reflagged Kuwaiti tankers, Iran attacked 54 commercial ships in the gulf and Iraq 63 for a total of 117 attacks. . . . In the nearly one year of escorting Kuwaiti tankers—July 22, 1987, through last Thursday—Iran replaced Iraq as the big attacker, shooting up 105 ships in the gulf compared to 82 for Iraq. The . . . total of 187 attacks since the escorts began represents a 60 percent increase over the previous year.

—*Washington Post*, July 17, 1988

## Usually they just reduce its value

Taking Stock: An SEC Reunion  
—headline in the *Washington Post*,  
June 18, 1988

CATO POLICY REPORT  
224 Second Street, SE  
Washington, D.C. 20003

ADDRESS CORRECTION REQUESTED

**CATO**  
INSTITUTE

Nonprofit Organization  
U.S. Postage Paid  
Washington, D.C.  
Permit No. 3571