IS SUPPLY-SIDE ECONOMICS WORKING? P. 10

POLICY REPORT

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Is the Dollar Too Strong?

by Steven K. Beckner

Now that everyone is talking about the unfortunate strength of the U.S. dollar, and now that the frustrated U.S. government has abandoned its program of intervening in foreign exchange markets, it is probably about time for the dollar to go into a nosedive. Unless the government changes its policy, the very forces that made the dollar strong could ultimately undermine it.

Actually, it is much too early to predict a major bear market in dollars, because the factors that drove the dollar to its recent peaks are still around, keeping it strong for the time being. But there are some early signs that the dollar may well fall.

Indeed, the dollar has already subsided from the level set on August 11, when its weighted average, as calculated by Morgan Guaranty Trust, reached 125.3—a record in relation to its March 1973 parities. At its peak, the dollar also stood 5.7 percent above its pre–June 1970 parities and 17.1 percent above its December 18, 1971, parities. As of mid-August, those numbers were down to 123.8, 4.5 percent, and 15.7 percent.

So it is hardly crash-and-burn time for the dollar yet. But the traditionally "hard" European currencies have begun to rally somewhat after the blow dealt the market when seven central banks dumped nearly $3 billion on the markets in a misguided joint program of currency intervention.

Pressure on the dollar has eased not because of intervention by central banks, which as usual proved largely futile, but because the figures released for money supply were more moderate than expected. These figures assuaged concerns in the market that U.S. interest rates would continue to surge upward.

It now appears that the dollar has at least reached a plateau against currencies such as the German mark, the Swiss franc, the Japanese yen, and the British pound. (The French franc is a special case; its value, because of President Mitterand's expansive monetary policies as well as new taxes and regulations that are scaring capital out of France, can be expected to continue shriveling.)

> **"One reason our interest rates have remained high is that the markets anticipate a resurgence of inflation."**

Most important is the relation of the dollar to the German mark. The psychologically crucial exchange level of 2.70 marks per dollar, although breached, did not hold. The dollar fell back to 2.68 after a few days at rates near 2.73, and has since sunk nearly to the 2.60 level. At its low point, the mark sank to 36.58 cents—abysmal when compared to its 1978 pinnacle of 57 cents. As the mark is the bellwether currency in the European monetary system, such a drop was, to say the least, worrisome; other basically sound European currencies—and not just the socialism-plagued French franc—were dragged down with the German unit.

What goes up need not necessarily come back down in the currency markets, but it is generally a good bet that it will. In early August, when the dollar was still on the rise, Herbert Stein (the American Enterprise Institute scholar who served as Chairman of President Nixon's Council of Economic Advisers) cautioned that once the upward momentum of the dollar was broken it could give way to a strong reverse trend. Once the "portfolio shift" into dollars is "satisfied," Stein predicted, "the dollar could fall very rapidly."

Ironically, if that happens, the U.S. Treasury and the Federal Reserve, which together undertook the recent intervention in foreign exchange to "calm disorderly markets," could find it equally disturbing and equally difficult to cope with depreciation of the dollar.

The Dollar and the Trade Balance

Right now, of course, the Reagan administration and American exporters would like nothing better than for the dollar to commence an extended downtrend that would boost American exports. Those exports become less and less attractive to foreign buyers as they have to pay more units of their own currency to buy dollars to purchase American goods. To hear them wail, the Europeans would also like a cheaper dollar in order to reduce the cost of their imports—particularly oil.

On the other side of the coin, of course, a more robust dollar makes it easier and cheaper for Americans to import the foreign goods they want. That is good for those of us who prefer foreign automobiles and so forth; but it is not so good for American producers. They were having trouble competing and were asking for protectionist walls even before the dollar became so expensive. For the Europeans, who are still languishing in recession, the prospect of a strong dollar

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Corruption in Government

It seems impossible to open a newspaper these days without reading about some new scandal or petty vice of a public official. From drunk driving to grand larceny and worse, those entrusted with responsibility for society's well-being have not, to put it mildly, demonstrated that they deserve such trust.

Consider just a few recent examples of official dining well at the public trough:

• While he looked for ways to cut the pay increases promised to city workers, Washington, D.C., Mayor Marion Barry gave his senior aides "incentive bonuses" of $5,000 or $10,000, including one to an official who had already announced his resignation.

• Assistant Secretary of Housing and Urban Development Emanuel S. Savas charged the government for two trips a month to his home in the New York suburbs, as well as using HUD staff to work on his book about how to cut government spending.

• Former Chicago Mayor Jane Byrne took a job with a firm that had received a $250,000 low-interest city loan in the final days of her administration.

Government officials have found a variety of ways to get around those pesky regulations that annoy the rest of us:

• Senator Roger Jepsen (R-Iowa) invokes congressional immunity when he is stopped for driving alone in the carpool lanes on Washington's Shirley Highway.

• U.S. senators avoided $48 million in postage during 1982 by using the franking privilege.

• Congress passed legislation in 1981 to give its members a major new tax deduction—large enough to wipe out all tax liability for many members—and on top of that added an amendment designed to prevent tax audits.

Perhaps the most disturbing aspect of this situation is the phenomenon of chicanery among officials entrusted with guarding the ethics of other officials.

• James Thompson, who was elected governor of Illinois on his reputation as a crusading district attorney, falsified key unemployment statistics in the midst of his reelection campaign, to keep federal money coming to the state.

• House Ethics Committee Chairman Louis Stokes (D-Ohio), found guilty of drunk driving, used campaign contributions to pay his lawyers.

• Rep. Donald J. Albosta (D-Mich.), who demanded a congressional investigation into misconduct in Ronald Reagan's 1980 presidential campaign, turned out to have a less than unblemished record himself. Albosta filed an improper application for a federal loan, helped his brother-in-law get a federal loan guarantee, paid congressional staff members for full-time campaign work, brought up an opponent's religion as a campaign issue, and committed minor violations in campaign finance reports.

The question is, are these scandals the exception or the rule? Do they represent the discovery of a few bad apples, or is the barrel rotten? The case of Donald Albosta sheds some light on that question. Albosta was an obscure congressman from rural Michigan who had never received any national attention, until he decided that his subcommittee could get some publicity by investigating the "Debategate" controversy. *The Washington Post* decided to do a little checking and discovered the above litany of petty scandals in Albosta's background. It makes one wonder how many politicians' records could stand up to the scrutiny of a good investigative reporter.

Some 70 years ago, the great economist and sociologist Vilfredo Pareto had some valuable observations on this question. His words are worth quoting at length:

> Politicians have to swaddle themselves in veils—often pretty diaphanous—of honesty. When one of them is trapped with his finger in the till, the opposition raises a great clamour of indignation—which does not prevent it from doing all it can to turn the scandal to its own advantage. If the alleged culprit's party fails in its efforts to exculpate him, it will cast him off as a ship in a storm throws out ballast. The public watches the affair develop with the fascinated interest of an audience at the theatre, and it becomes high drama free of charge if by any chance there is in the affair an element of sex or human interest. Trivial minor issues push the main issue aside, and *the real issue—the social and political system which begets such scandals*—is entirely disregarded. . . . Moralists assume that it is the fortuitous rise to power and influence of a "dishonest" man which has provoked the scandal, arguing as if it were equivalent to a cashier's embezzling his firm. But there is no parallel between the two cases. *It is not by fortuitous circumstances that such a man is raised to a position of power; it is by selection at the dictates of the very nature of the system.*

A government that has a great deal of power will attract the interest of those who want to wield power or to benefit from wielding it. As long as government has the power to hand out $800 billion a year, "scandals" will occur, and only the naive will be shocked. ■

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presents an opportunity for an export-led recovery. They are enjoying the inverse of our snowballing merchandise trade deficit.

The inexorable rise of the U.S. dollar against the other major currencies is startling, perhaps even disturbing; but it is not particularly puzzling. Using the traditional measuring stick of purchasing-power parity, the dollar is clearly "overvalued"—by roughly 30 percent, according to most economists. In other words, if one totaled the prices of a basket of goods in Germany and one in America and worked out a ratio, one would not come up with 2.70 marks per dollar. Nor would one arrive at a ratio of 2.18 Swiss francs per dollar or 245 Japanese yen per dollar on the basis of the purchasing-power parities of those currencies.

The gaping U.S. merchandise trade deficit—having hit a record high of $42.7 billion in 1982—is expected to exceed $60 billion this year and reach $100 billion next year. This state of affairs does not seem to speak well for the dollar either. How, people wonder, can America have a strong currency when its balance of payments is so dismal?

Interest Rates

What gives the dollar its momentum? The fairly obvious answer is that international investors and money managers, ever on the lookout for the best yields, have found dollar-denominated money market instruments attractive because of America's high real interest rates.

There are other factors. Political and economic uncertainties elsewhere in the world, coupled with the strong recovery here, make dollar-based investments even more desirable. The image of America as a safe haven from political and economic uncertainties is a factor in strengthening the dollar, but surely the international climate has not deteriorated to that extent from the late seventies, when the dollar was a sick currency.

Fundamentally, interest rates—real interest rates—are the name of the game. At least, they *have* been the name of the game. But this may be changing. A growing minority of analysts are predicting that nominal interest rates will fall later this year, but even if nominal rates stayed where they are, rising inflation would serve to lower real interest rates.

The dollar gathered steam because the drop in America's rate of inflation to below 4 percent outpaced the decline in both domestic and foreign interest rates. The result was gaps in real yield—of 5 percent and more—in relation to money market instruments denominated in other currencies. Paradoxically, though—and this is the key—one reason our interest rates have remained relatively high is that the markets anticipate a resurgence of inflation. Therefore they include an inflationary risk factor in long- and even short-term interest rates. In view of the expansionary policies the Federal Reserve has pursued since last fall, the markets are fully justified in their fears.

In other words, to a certain extent the dollar is strong because people believe that its underlying purchasing power is going to deteriorate over time. Obviously, this attitude is not a sustainable one. Inflationary expectations are the achilles' heel of the dollar.

The other reason why interest rates are so high is the heavy demands the Treasury is putting on the capital markets—in competition with credit-hungry consumers and businessmen—to finance the unprecedented federal deficit. Combined public and private borrowing pushes interest rates up, which attracts capital to America, which drives the dollar up. Our merchandise trade may be sinking deeper and deeper into the red ink, but our overall balance of payments appears relatively healthy because we are absorbing the savings of the rest of the world.

As Council of Economic Advisers Chairman Martin Feldstein has pointed out, whether policy makers intended the effect or not, the strong dollar is indirectly helping to meet the federal borrowing requirement and to finance the recovery—a recovery that might otherwise be crowded out by government borrowing. Last year, net official capital outflows ($5.8 billion), net inflows through the nonbank private sector ($17.8 billion), and net outflows through the banks ($43.8 billion) were relatively unchanged,

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The Hazards of Budget Forecasting

by Randolph H. Boehm

Proponents of a national industrial policy want the government to gather data and coordinate production in the economy. But can the government plan the economy if it can't even predict future economic events?

Throughout the 1970s, Keynesians were chagrined by the emergence of simultaneous inflation and rising unemployment—"stagflation"—a phenomenon they neither predicted nor one which their economic theory could explain. And then there was President Nixon's explanation that the "full-employment budget" scheme would work like a "self-fulfilling" prophecy with the federal government spending its way out of deficits to maintain low (4 percent) unemployment and inflation-free economic growth. "We're all Keynesians now," declared the President. And unemployment shot up to 8.5 percent by 1975, while inflation held steady at 9.1 percent, as measured by the Consumer Price Index (CPI).

Seizing on the confusion among the Keynesians, supply-siders moved ahead with confident predictions of their own in the late 1970s and early 1980s. Although many economists remained skeptical of the idea that tax cuts alone could prove to be the new "self-fulfilling prophecy" regarding economic growth and fiscal health, supply-siders gathered enough qualified support to line up a consensus behind the initial Reagan budget. Barely had the boasts of "We're all supply-siders now" died down than it became clear that monetary policy might have to be considered too. And the great "riverboat gamble" of cutting taxes while raising expenditures left the nation holding the twin jokers of sharp recession and huge deficits.

Randolph H. Boehm is an editor at University Publications of America. This article is based on a study for the Cato Institute.

Today's debate centers on how to limit the impact the impending deficits will have on interest rates and future economic growth. A perspective that seems to be altogether missing from that debate, however, is an understanding of how chronically unreliable economic forecasts, and hence budget projections, really are. A careful examination of previous federal budget forecasts bears this out. Checking the accuracy of past federal budget projections for three macroeconomic assumptions (the GNP, the unemployment rate, and the rate of inflation as measured by CPI) as well as for three major fiscal accounts (outlays, receipts, and the deficit), yields quite sobering results.

Presidential forecasts missed the annual percentage change in the CPI by an average of 130 percent between 1976 and 1982. They misforecast the change in unemployment by an average of 51 percent over the same period. Forecasts of the change in GNP were off by an average of 23 percent for fiscal years 1977-79 and 1981. The 1980 GNP forecast was awry by a startling 1350 percent. Longer range forecasts tended to be even worse. Not surprisingly, with such error-prone economic assumptions the fiscal projections were chronically and widely amiss. Between 1971 and 1982, the magnitude of change in the federal deficit was misforecast by an average of 530 percent.

Part of the reason for this record certainly lies in the fact that major unforeseen events are commonplace in our modern world economy. Forecasts are basically an effort to assess present trends and to project them into the future. But thanks to the dynamics of invention, technology, entrepreneurial ingenuity, and human preferences, the record of econometric forecasting since the Second World War is an almost endless litany of bloopers. Not only are the forecasts chronically inaccurate, but many of the concepts we take for granted in economic discourse are themselves controversial and potentially misleading.

Given the facility with which many economists and policymakers juggle aggregates such as the gross national product (GNP), the deficit, or the unemployment rate, the layman is too inclined to think that the experts are able to manipulate economic variables just like simple integers in an equation. Nothing could be further from the truth. A major—but often overlooked—reason for the economists' poor forecasting record lies in the artificial constructs they work with. The concepts of GNP and the unemployment rate aren't as simple—let alone manipulable—as economists would have us believe. Instead they are very rough aggregates that can easily mislead us.

Take GNP, for instance. The GNP concept includes both too much and too little in an attempt to measure the size of the national economy. Since it computes only cash flows, it either ignores economic transactions where no money is exchanged or else assigns an arbitrary value to the transaction. This excludes such major contributions to economic wealth as the work of housewives, home labor of children, and volunteer work, as well as major unrecorded cash flows in the underground economy. Government expenditures are included in GNP, even though many economists believe that much government activity actually diminishes real wealth. Necessarily controversial, measurements of capital depreciation also have an impact on GNP. Finally, the data gathered by government itself must be regarded as highly suspect, particularly when we remember that the massive 1970 census missed 4 million Americans, by the Census Bureau's own estimate.

One would never guess that these aggregate concepts are at all limited, judging from how much they are cited in discussions of economic and fiscal policy. So oblivious have we become to these limitations that legislators increasingly look to measurements like GNP as "trigger" mechanisms implementing all sorts of economic policies, from contingency taxes and anti-recession relief to spending limits and indexing schemes for taxes and entitlements. Many decisions in federal budget politics are made on the basis of predicted changes in these dubious aggregates.

A misguided notion can be a dangerous thing when the stakes involve sweeping economic legislation or decisions affecting hundreds of millions of dollars in the federal budget. With the rising clamor for far-reaching government direction of industrial and foreign trade policy, one would think that the issue of the *limits* to national economic planning—as shown clearly by the federal government's own budget projections—would draw more attention.

This isn't to say that government economists themselves aren't aware of the problem. Indeed some of the strongest criticism about the use of economic aggregates can be found in the publications of government agencies. The message is there. Is anyone listening? ■

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according to the 1983 annual report of the Bank for International Settlements. "However," the BIS report went on to say, "the balancing item, which in the main probably consists of unidentified capital inflows, exceeded the already high 1981 figure of $25.8 billion to reach an unprecedented $41.9 billion, broadly offsetting the deterioration in the current account." Thus, because of an uncontrolled appetite for federal spending, America is sacrificing its international competitiveness—trading exported goods for imported capital.

Renewed Inflation Ahead

The big question hanging over the future of the dollar is, Can interest rates keep pace with inflation? They have not in the past. Real interest rates are high, hence strengthening the dollar, because we are passing through a lull in the inflationary storm. And that is the way the markets view it. Surveys of businessmen have shown that the markets expect inflation to rise by at least 5 to 6 percent in the coming years. That is probably a conservative expectation.

Of course, for those who believe we are living in a "disinflationary age," as the current conventional wisdom has it, there is little to worry about. However, there are abundant indications that inflation is merely sleeping. The monetary aggregates have been galloping along at double-digit rates for nearly a year now. Much has been made of the recent modest attempt by the Fed to restrain credit. But taking the longer view, we see that the money supply is still growing disproportionately to the current 3-percent rate of inflation.

Having overshot the target range for growth of M-1 (currency in circulation plus checkable deposits) twofold, Federal Reserve Chairman Paul Volcker announced during his midyear monetary policy report to Congress that the Fed will take that big monetary bubble as given. The Fed will simply increase its target range of 4 to 8 percent for the remainder of the year to 5 to 9 percent.

"Political and economic uncertainties elsewhere in the world, coupled with the strong recovery here, make dollar-based investments even more desirable."

The commodity futures markets, which have good records of anticipating prices generally, have responded to the inflationary storm warnings with a strong rally in the grains. The markets in precious metals, while they remain fairly calm, have shown surprising buoyancy, considering the high interest rates. They could be poised for a new takeoff. Meanwhile, the stock market has suffered major setbacks, largely due to fears of revived inflation and the policies that the government will probably take to deal with it.

Currencies in the other industrialized countries will continue to be depressed only if their rates of inflation rise with ours or if their rates of interest fall in relation to ours. Certainly if both conditions obtain, their currencies will necessarily remain low.

The record strongly suggests that in a new inflationary cycle, the United States will outpace its trading partners. "From 1975 to 1982, wholesale prices rose about 72 percent in the United States, 36 percent in Japan, and 38 percent in Germany," Stanford University economist Ronald McKinnon observed in April. "Only in 1982–83 have the three countries converged to the same absolute rate of inflation—close to zero. But the cumulative impact of the higher American inflation since 1976, combined with the sharp appreciation of the dollar in 1981–82, has left both the yen and the mark undervalued."

The record also shows that whenever the demands for credit of the public and the private sector have conflicted, whenever confronted with a Hobson's choice of either letting government borrowing stunt economic growth or adopting an accommodative monetary policy, the government has always chosen the inflationary course. And in the long run, inflationary monetary policies have always led to a depreciating currency. ■

Foreign Debt: The Politics of Default

Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters, where distinguished analysts present their findings to an audience drawn from government, the public policy community, and the media. A recent Forum featured Mark Hulbert, editor of the Hulbert Financial Digest *and author of* Interlock, *a book examining the international financial aspects of the Iranian crisis. Commenting on Hulbert's talk was Robert Solomon, guest scholar at the Brookings Institution and author of* The International Monetary System, 1945–1981.

Mark Hulbert: The politics of lending to foreign governments as well as the politics of collecting those debts once they are lent are crucial issues today, with many observers prophesying various disaster scenarios of what will happen when that debt crisis is resolved. What I propose to review today is the lessons of prior historical incidents in which nations have defaulted. For example, defaults of governments have been more prevalent under certain circumstances than others and certain governmental attempts to deal with excessive foreign lending have been more successful than others.

Today, I will confine my remarks to three matters. First, I propose to ask the question: Under what conditions do governments default? Second, I propose to look at past governmental attempts to regulate foreign lending. And third, I will look at the official attitudes toward foreign lending today.

The first question is rarely asked, because the answer is thought to be so obvious; a nation defaults when its finances have so deteriorated that it is simply unable to meet its external obligations. Yet this answer does not account for historical instances of sovereign default. As a rule, nations that have defaulted have *not* done so when they were least able to pay. To use a classic example, at the time Germany defaulted on its war debts to the United States in 1933, it was far more able to pay those debts than it had been in the early 1920s. Why then did Germany default in 1933?

If one distinguishes between default as a nonnegotiable repudiation of external obligations and debt service difficulties unaccompanied by threats of repudiation, the answer will be clearer. While the latter is more prevalent during times of economic hardship, it has little correlation with outright default. Since the late 1950s, for example, there have been over 80 instances in which less developed countries (LDCs) have been unable to meet their debt service obligations to Western banks; this inability led to the rescheduling of more than $60 billion of loans. Yet none of those instances led to outright default. Nonnegotiable repudiation of external

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debt is a political act, the end result of a geopolitical calculations comparing the costs and benefits of such repudiation. Ability to pay is only one, and historically a relatively minor, component.

If debt repudiation meant the cessation of all economic and political ties with the world, to pose a hypothetical extreme, then it is most likely that no country would repudiate its debt. It would simply enter into rescheduling negotiations, and some accommodation no doubt would be worked out. But outright repudiation rarely carries such extreme consequences, and the less severe the consequences the more likely it becomes. Cuba repudiated its debt to Western banks in 1962, for example, because the country was already isolated from the Western alliance, both economically and politically. Default had no adverse consequences because the country was firmly within the Soviet bloc, and the USSR was hardly about to retaliate against Cuba for defaulting on debts to the United States.

As a generalization it is fair to state that as in Cuba's case, debt repudiation occurs as a country shifts between geopolitical blocs. If a country is so firmly within a bloc that expulsion would be intolerable, debt repudiation is unthinkable.

The same lesson can be drawn from foreign defaults during the 1930s. Despite the deterioration of economies worldwide, only one-third of all foreign bond issues floated in the United States were actually repudiated. According to a study conducted by the National Bureau of Economic Research (NBER), those bonds were not, by any of several criteria, intrinsically worse than the two-thirds that remained good and were serviced through the 1930s. The determining factor in the defaults, it turned out, was geographic area. In addition, the countries that did default were not scattered randomly around the globe, but instead formed clusters—almost exclusively in Eastern Europe and in Latin America. Although the NBER study does not attempt to explain the cause of this skewed geographical distribution, it is true that Eastern Europe and Latin America were the regions where the American sphere of influence was weakest and where cooperation between creditor governments to enforce collection of debts was least likely. Therefore it was in these regions that debtor governments perceived default to be least costly; not surprisingly, many defaulted with impunity.

The fact that more governments repudiated their debt in the 1930s than before was due not to the fact that the Depression was more severe than previous economic downturns, but was because political and economic cooperation between governments had reached new lows. The lesson for the 1980s is clear: A failure of political and economic cooperation among Western nations (for example, a resurgence of protectionism) increases more than anything else the likelihood of widespread debt repudiation.

The second area I would like to discuss today is the record of governmental attempts to regulate foreign lending. It is one of the ironies of the politics of foreign debt collection that while such debts presuppose a high degree of cooperation among creditor governments to insure that they are collected, the very existence of high levels of debt can seriously erode and strain such cooperation. A study conducted in the late 1930s by the Department of Finance at New York University, for example, concluded that "economic coercion through special trade clearing arrangements has proved to be the most effective means of obtaining debt service on external obligations from recalcitrant debtors." In addition to endangering political cooperation through a breakdown into trading blocs, high levels of debt also can lead to military confrontations—as European attempts in 1902 to collect Venezuelan debts almost did. Clearly, as a Council on Foreign Relations study concluded from its examination of foreign lending, "debts are not the kind of bond which can unite the world."

Despite these long-term threats to political cooperation, foreign lending is very attractive to creditor governments as a tool of foreign policy. Holding back on loans is a potent threat when used against recalcitrant governments, while the promise of large and steady flows of credit is often effective in encouraging friendly behavior. These advantages are even greater when the credit is extended by private lenders, in which case the government achieves its foreign policy goals with no immediate budgetary costs.

Like governments, private lenders are also confronted with conflicting incentives. Banks are sensitive to changes in official attitudes toward foreign lending, and generally are unwilling to lend to a foreign country unless their home government appears willing to assist in collecting the debts. On the other hand, because domestic lending often is less lucrative, banks have an incentive both to exploit favorable official attitudes toward foreign lending and to encourage governments to extend their spheres of influence.

The current active government support for private foreign lending dates back at least two decades and, if anything, exceeds the extent of official encouragement for such lending in the late 1920s. As early as 1962, for example, the following type of signal was being sent to the banking system—this one from the new nominee for the Comptroller of the Currency. In hearings on his nomination to that post, James B. Saxon said, "I believe we need more education and more purposeful efforts by the authorities on a sound, sane basis to amplify the participation of the American banking system abroad. . . . One of the purposes of this inquiry is to see if by changes in law and changes in administrative procedure and policies the activities of more banks in this area can be properly expanded." According to Former Federal Deposit Insurance Corporation (FDIC) Chairman Frank Wille, the Federal Reserve's attitude throughout the 1960s and 1970s was that of a "cheerleader." Jane D'Arista, presently of the Congressional Budget Office, in a 1975 study for the House Banking Committee, argued that "it appears likely that banks have assumed that these loans are in some sense guaranteed—that some form of governmental assistance will be given to a country to prevent a default that might threaten major banks."

Warren Coats of the IMF talks with Gordon Tullock of the Center for Study of Public Choice.

Following the worldwide recession of 1975 and 1976, which caused unexpectedly severe problems of debt service for many nations, many began to question the wisdom of continued lending to the Third World on the part of commercial banks. The debt of many LDCs was growing faster than their economies and thus faster than those countries could repay the loans. Yet it was unclear whether either the LDCs or the banks themselves would be the source of prudent limits on the growth of debt. Unfortunately, the U.S. government also did not take the lead in urging such prudent limits.

John Early, director of Bank Supervision at the FDIC, far from expressing any alarm about the patterns of Third World lending, testified in 1977 before the House Banking Committee that "on the basis of information we review as a matter of course, we believe recent commitments to Third World countries pose no real danger to the overall stability of the U.S. banking system." And C. Fred Bergsten, Assistant Secretary

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of the Treasury at that time, testified, "We reject the view that international lending activities of American banks are posing grave risks to the American economy or banking system. We believe, to the contrary, that they have been remarkably successful in playing a vital role in helping to finance an unprecedented level of international trade, capital flows, and payments imbalances—and that they continue to enjoy such success." In such an environment it should be no surprise that bank loans to Third World nations grew as dramatically as they did.

Finally, I would like to suggest some policy implications for today. As pointed out earlier, failure to cooperate on the political and economic fronts increases the likelihood of widespread default more than anything. Has the debt of the Third World surpassed the willingness of creditor governments to cooperate in collecting it?

Although political cooperation is not as lacking today as it was in the 1930s, it has deteriorated over the last two decades. For example, when Cuba chose to join the Soviet bloc, the United States was able to get most other Western nations to cooperate in isolating Cuba, both politically and economically. It would be difficult for that much cooperation to be achieved today.

The most dramatic example of this recent deterioration of cooperation came in the Iranian hostage crisis. Although Iran detained American personnel and the United States contended that Iran had defaulted on its loan obligations, the United States could not secure enough cooperation to isolate Iran. A similar lesson can be learned from Britain's attempt to gain Allied cooperation in its South Atlantic conflict last year.

The lesson of the Iranian case is that creditor governments today are much less likely to sacrifice their own relations with one country to help another government collect debts or, in general, impose any sanctions. Yet as debt burdens grow, more coordination, not less, will be needed to assure eventual collection. The risk is that debts will grow beyond the point where governments are willing to cooperate; history teaches us that at such a time, trade barriers and protectionism can turn cooperation between blocs into competition.

The Treasury Department's arguments for the International Monetary Fund (IMF) quota increase are a case in point. We should support that increase, Secretary Regan argues, "in defense of the average American and his own economic interests. The purpose is to protect his job and his income." If the quota increase is not approved and the Third World countries are unable to continue borrowing, Regan continues, exports of industrial nations to the

Robert Solomon

Third World would be reduced by $35 to $40 billion—by $12 billion in the United States alone. The conclusion readily follows: Third World economies should be propped up so that they can continue to borrow large amounts, and so that industrial countries in turn need not forego economic growth. The Administration accordingly terms the quota increase a "jobs" bill.

It seems, then, that official policy is to encourage Third World countries to continue borrowing at a rate comparable to past rates. Lower levels of debt are thought not to be in American economic interests. But not all of the industrialized nations can expect to base their economic growth forever on debt-financed purchases of their exports. As debt burdens grow faster than their economies (which most econometric forecasts predict), more and more of the Third World countries' current accounts will have to be devoted to debt service—with correspondingly less available for buying exports from the industrialized nations. Competition among the increasingly export-oriented Western economies will become more fierce as markets in the Third World dwindle. As in Iran's case, creditor governments may refuse to sacrifice relations with a particular country—and markets for their exports—in order to cooperate with another government's efforts to collect on its debts. U.S. policy, in other words, makes a breakdown into competing blocs more likely rather than less. As Secretary Regan's choice of words illustrates, support for the quota increase has a somewhat protectionist motivation.

Robert Solomon: I'm trying to distill Mark Hulbert's major message to us. The message seems to be: In order to collect on debts—even the debts of its banks—a country needs the cooperation of other countries of the world. Such cooperation seems less likely now than in the past; therefore loans by banks from the United States to developing countries are at greater risk and therefore, presumably, such loans should be discouraged. And that in turn implies that probably the increase in IMF quotas is not good.

Now let me address myself to some of the substance of what Mr. Hulbert explicitly said. He argues that in the 1930s, default or repudiation was not a result of the Depression but of the breakdown in international cooperation. And he observes that the defaulting or repudiating countries were not randomly distributed geographically but were concentrated in Eastern Europe and Latin America. These are the areas of the world that at that time in particular produced food and raw materials whose prices plummeted during the Great Depression. Those countries were hit very hard in the 1930s Depression. It would take a lot more evidence to persuade me that the Depression was not the main cause of repudiation or default in those areas.

The second part of Mr. Hulbert's paper makes the point that private lending abroad tends to respond to promotion by governments. I do not find the evidence very persuasive. He makes the point that if government (particularly the Department of State) denies a private lender, that private lender responds. In my experience as an official, I would say that that is correct. But I do not find evidence that the U.S. government has actively promoted lending abroad by American banks. Banks had their own incentives for lending abroad, and they are not very responsive to the wishes of the government.

The most important omission in this discussion is the economic performance of the major debtors, the countries that have received the bulk of these loans. We all know that the largest debtors are Argentina, Brazil, and Mexico. These and a couple of other countries account for three-quarters of all bank loans, not only those of the United States but also bank loans from industrial countries to all nondeveloping countries.

Just take a look at the economic performance of Argentina, Brazil, and Mexico in the 1970s. From 1970 to 1979, until the recession of 1982, export volume increased at an annual rate of 10.7 percent in Argentina, 9.1 percent in Brazil, and 10.9 percent in Mexico. That is two to three times the rate of growth of world trade during the same period. These countries must have been doing something right. They must have been using the inflow of capital in a productive way if they were able to export products at that rate in the 1970s. Two of those three countries had very healthy rates of growth of gross national product as well, but in the 1970s the real GNP increased at an average annual rate of 8.7 percent in Brazil, 6.4 percent in Mexico, and 3 percent in Argentina, although exports grew very rapidly. The point is that the economic performance of these countries made them look like attractive debtors who could sustain debt. The banks did not need to be pushed into lending to them.

The second problem is that since 1979 we have experienced the worst recession in the industrial world since before World War II. It affected the export volume and the export prices of the major debtors. I think lenders have every reason to expect cyclical fluctuations in the economies of the countries to which they are lending, and prudence should have taken that into account. But there was no experience in recent years to make them expect so long a period of stagnation and recession as we have experienced since 1979. And that recession in the industrial countries has had a very strong impact on the exports of these developing countries. That recession, plus the very high interest rates in the industrial countries, swelled the balance-of-payments deficits of these debtors and made it difficult for them to pay interest on their debt. That seems to be a relevant fact.

Finally, these conditions that I've just described—recession with its effect on the balance of payments of the developing countries in particular—are precisely the conditions that the IMF was created to handle. So the case for increasing the IMF quota is indeed a strong one.

So in conclusion, in contrast to Mr. Hulbert's view that government should stop encouraging lending by banks, I believe that the U.S. government should support a larger International Monetary Fund and should encourage continued bank lending, as in the past year, in order to keep funds flowing to developing countries for their own political and social stability as well as because it helps provide jobs in the United States and in the rest of the industrial world.

Mark Hulbert: Mr. Solomon says there is another reason why Eastern Europe, Central Europe, and Latin America were the geographic areas where defaults were clustered in the 1930s: The price of their commodities, a major item of their export earnings, plummeted. The major reason that commodities prices fell was the drastic breakdown in world trade. Between 1929 and 1933 the value of world trade dropped from $3 billion to $940 million a year. So these nations that were dependent on exports were in bad shape. That in itself, though, cannot explain why those nations and not others were involved in default. According to the National Bureau of Economic Research, some countries had economies that were objectively in a worse state than those that defaulted. NBER found that the only statistically significant correlation to explain the defaults was geographic area—not any other criteria.

The IMF has also lost some of its legitimacy from the point of view of the banking system. We can see that in the last year or so IMF support has not proved the catalyst to bank lending that it has in the past. In fact, the IMF has to twist the arms of banks in order to have them continue lending, which I think is prima facie evidence that the banks do not have the confidence that they once did in the IMF's really setting down the conditions for economic growth and prosperity.

To sum up, the IMF has two sources of influence and power in the world. One is its money and the other is its legitimacy or credibility. It has made the mistake of looking to money rather than to legitimacy as the major source of its power. If the IMF had less money, it would be more concerned about its credibility and would actually enforce conditions for access to the credit market. The IMF does not need more money in order to play that enforcement role, because banks are more than willing to let the IMF first negotiate a standby agreement with those governments. Then the banks will lend the money—after the standby agreement has been signed. A Third World government will negotiate with the IMF realizing that those banks are ready to lend money if the IMF signs such a standby agreement. ■

The Future of the Supply Side

The Supply-Side Solution, *edited by Bruce Bartlett and Timothy Roth (Chatham, N.J.: Chatham House Publishers for the Manhattan Institute, 1983), 289 pp., $12.95.*

Foundations of Supply-Side Economics: Theory and Evidence, *by Victor Canto, Douglas H. Jones, and Arthur B. Laffer (New York: Academic Press, 1983), 283 pp., $35.*

Supply-Side Economics in the 1980s: Conference Proceedings, *sponsored by the Federal Reserve Bank of Atlanta and Emory University Law and Economics Center (Westport, Conn.: Quorum Books, 1982), 297 pp., $35.*

The Truth About Supply-Side Economics, *by Michael K. Evans (New York: Basic Books, 1983), 294 pp., $17.95.*

Since its intellectual renaissance in the late 1970s and since the Reagan administration embraced it in the 1980s, supply-side economics has met with varying fates. Now there seem to be at least five schools of thought on the supply-side experiment:

(*a*) There was no supply-side experiment.

(*b*) The supply-side experiment was aborted.

(*c*) The supply-side experiment failed because supply-side economics is wrong.

(*d*) The supply-side experiment failed because it was not combined with other policies such as budget cuts, a gold standard, or regulatory reform.

(*e*) The supply-side experiment succeeded (this position is held only by the Reagan administration).

The most interesting question about supply-side economics today is whether (*a*), (*b*), (*c*), (*d*), (*e*), or some combination of the choices correctly describes the situation. I am inclined to select some mix of (*a*), (*b*), and (*d*), with an emphasis on (*a*). In support of point *a*, the tax cuts enacted by the Reagan administration were not cuts at all—they were decreases in the rate of tax increases. Furthermore, in line with point *b*, these "cuts" were almost completely wiped out by bracket creep and increases in Social Security taxes. Nonetheless, there is still some validity to point *d*. If Reagan's original fiscal policy had been combined with offsetting spending cuts, it would have been a modest success. While such minor changes would not have succeeded in turning the economy around, the policies thus engendered would have been preferable to those of the Carter administration. Point *b* entered the scene once deficits started to balloon and Reagan instituted the largest peacetime tax increase in American history.

As things worked out, this combination of aspects of (*a*), (*b*), and (*d*) gave us the worst of all worlds. Instead of tax cuts, we ended up with real tax increases *and* skyrocketing deficits. Furthermore, the so-called "tight money" policies of the Fed did not convince anybody that inflation was ending. Yet only two years after this catastrophe got underway, the American economy finds itself in the midst of a strong recovery. Both production indices and the stock market continue to rise, while inflation is well below the double-digit level. Unemployment, while still high, has been consistently falling.

Policy Report Reviews

Thus we have seen two complete turnabouts in the last two and one-half years. Any book on supply-side economics that can help explain these events deserves praise. When judged by these standards, of the four books under consideration, Michael Evans' *The Truth About Supply-Side Economics* (while only half correct) gets the highest marks. Although the other three contain some very interesting material, they are neither as relevant nor as timely as the Evans book. Nonetheless, all of the books are articulate examples of supply-side thinking.

As the title indicates, Bartlett and Roth's *The Supply-Side Solution* is the most ardently pro-supply-side of these books. This book is primarily a collection of reprints of well-known articles in supply-side economics. Besides Michael Evans, among the contributors are Norman B. Ture, Paul Craig Roberts, Michael Boskin, Arthur B. Laffer, and Otto Eckstein.

Two of the best-known (and best) articles in this volume are "The Bankruptcy of Keynesian Econometric Models" by Evans and "The Breakdown of the Keynesian Model" by Roberts. Evans argues convincingly that all Keynesian econometric models are inherently flawed because they assume that increases in aggregate demand are noninflationary and because they ignore supply-side incentive effects. Evans himself was intimately involved with construction of the Wharton and Chase econometric models. While one can applaud Evans's conclusions, the point he seems to miss is that *all* econometric models, not just Keynesian ones, are seriously flawed. Roberts's article, reprinted from the 1978 *Public Interest*, is a classic supply-side manifesto containing an excellent discussion of the importance of incentives.

The other essays in this book are of mixed quality, as they often fall prey to some of the weaknesses of supply-side thinking (see Thomas Hazlett's essay in Richard Fink's *Supply-Side Economics: A Critical Appraisal* for a critique of these weaknesses). Specifically, much of the analysis deals with meaningless aggregates or refuses to consider the fact that maximization of government revenue may be *bad*. In spite of these reservations, Bartlett and Roth have produced a useful collection, with a valuable bibliography for anyone interested in further research on the subject.

The second book, *Foundations of Supply-Side Economics: Theory and Evidence* by Victor Canto, Douglas H. Jones, and Arthur B. Laffer, is the most theoretical of the four. The bulk of this work consists of neoclassical modeling and empirical tests of these models by the three authors. To round out the book, Paul Evans, Marc A. Miles, and Robert Webb have contributed similarly empirical chapters.

This is not so much a book as a collection of separate chapters and models. Some sample chapter headings are: "Taxation in a Closed Economy Intertemporal Model With a Variable Supply of Labor to the Market Sector," "Government Fiscal Policy and Private Capital Formation—Some Aggregate Time-Series Estimates," and "Persistent Growth Rate Differentials Among States in a National Economy with Factor Mobility." Other chapters cover the Kennedy tax cuts, tax incentives and labor supply, and the relationship between supply-side economics and macroeconomic policy.

Like the Bartlett and Roth work, this book also comes down on the side of the supply-siders. Yet the arguments are less interesting, less general, and less convincing. We are given very little in the way of a conceptual comparison between supply-side economics and other schools of thought—there seems to be no compelling reason why we should favor one way of looking at the world over any other way. The closest thing one finds to an argument for supply-side economics is a series of estimated coefficients seeming to imply that increases in marginal tax rates will decrease the labor supply and aggregate output.

It is not proper to condemn this book outright for its preponderance of empirical modeling—clearly the authors intended that emphasis. Nonetheless, it renders *Foundations of Supply-Side Economics* a work for the research specialist only.

Supply-Side Economics in the 1980s: Conference Proceedings is the most casual and entertaining of our four books. Most of the chapters are not academic papers but transcripts of talks delivered at the conference. Among the speakers are Murray Weidenbaum, Michael Boskin, Jack Kemp, David Meiselman, Paul Craig Roberts, Milton Friedman, Lawrence Klein, Martin Feldstein, Thomas Sargent, and Beryl Sprinkel. Most of the talks are short and entertaining, albeit somewhat predictable. The book also contains academic papers by Gerald P. Dwyer, James Buchanan and Dwight Lee, and James Gwartney and Richard Stroup.

Most of the material here is sympathetic to supply-side economics, but there is a wide range of views. Interspersed among the ordinary and predictable words are a number of excellent points. For instance, Milton Friedman on the Laffer Curve: "I know that there's been a lot of talk about how you can cut tax rates without cutting revenues. From my point of view, I want to cut tax rates; but if the Lafferites were correct in the most extreme form—that a particular cut in tax rates increased revenue—then my conclusion would be that we hadn't cut tax rates enough, because what I want to cut is government revenue. That's what feeds government spending."

Another of the better talks was given by Frank Morris, president of the Federal Reserve Bank of Boston. Morris argues, "I have reluctantly come to the conclusion that we can no longer measure the money supply in the United States. By that I mean that we know our statistical systems can no longer easily differentiate money from other liquid assets." Morris discusses the problems of defining and measuring the money supply and then goes on to question using monetary aggregates for targets of policy. Unfortunately, Morris never questions the crucial role of the Federal Reserve, and whether it should be conducting any monetary policy at all.

Although the free-market critique of supply-side economics is underrepresented in this book (as is the case with all four books), *Supply-Side Economics in the 1980s* makes good browsing if one is interested in other contemporary views on the supply-side experiment. The reader will find all five of the positions (*a-e*) on my list in this book.

Finally, we have Michael Evans' *The Truth About Supply-Side Economics*, the most ambitious book of the four. Unabashedly exploiting the benefits of hindsight, Evans tries to explain what went wrong with the Reagan experiment. Most of the book is an explanation of some supply-side truths and fallacies. Evans presents four myths that in his opinion damaged the Reagan program: "Myth 1: Interest rates would decline as soon as the Reagan program was announced. Myth 2: Tight money and fiscal ease can generate balanced, non-inflationary growth. Myth 3: Business tax cuts would increase investment immediately. Myth 4: The Reagan Economic Program would balance the budget by 1984."

Despite these myths, Evans still believes that there are enduring truths to supply-side economics. Higher rates of return will increase personal saving and work hours; lower marginal tax rates (especially on capital gains) will spur economic growth in the long run. The problem with Reaganomics is that it put too much stock in the four myths and did not rely enough upon the enduring truths. Evans suggests that the Reagan program would have been more successful if it had been combined with spending cuts, serious regulatory reform, and a less stringent monetary policy.

While Evans is generally correct about the supply-side myths and truths, his policy recommendations are questionable. His call for faster monetary growth, an unfortunate part of too many supply-side analyses, is a prescription for inflation. In any case, as long as there is a central bank empowered to conduct monetary policy, it is unlikely that any fiscal reforms can bring long-run stability and growth. If, as Frank Morris argues, the money supply can be neither defined nor measured, how can we rely upon a central bank to pursue the proper monetary policy, *even if it wanted to do so?* Instead, free banking and massive spending cuts in all areas are the best partners for a true supply-side fiscal program. ■

—*Tyler Cowen*
Harvard University

"To be governed . . ."

Chrysler, the good-example company

The government's decision to auction off its rights to 14.4 million shares of Chrysler Corp. stock could stifle the resurgent company's return to financial health, a ranking Chrysler official warned yesterday. . . .

[Chrysler Vice Chairman Gerald Greenwald] said the government's decision to sell the Chrysler warrants "is clearly setting the wrong example."

—*Washington Post*, Aug. 3, 1983

No freelancing allowed

A federal jury has convicted a driver for the Internal Revenue Service in the robbery of a branch of the First Virginia Bank in Alexandria.

—*Washington Post*, Aug. 6, 1983

Let's call this one "Peace"

Since the dawn of the nuclear age, the United States has announced the testing of 724 nuclear devices, each with a distinctive moniker. Just as meterologists like to give names to destructive hurricanes, nuclear weapons scientists identify their more catastrophic devices in a number of ways. . . .

After she turned down a number of other names, including sacred Indian words, [weapons information specialist Terry] Egan issued a memo to the labs: "Words should not be submitted for approval which connote or imply by their meaning aggressiveness, a relation to war, weapons, explosives, the military, potentially sensitive situations or other categories which in some way reflect on weapons programs."

—*Washington Post*, Aug. 7, 1983

The free-rider problem

In the past fiscal year, Boston took in $22 million in [parking-meter] fines and $4 million in meter revenue, quadrupling the take before 1981. The ticket collection rate soared to 70%. . . .

Deputy Mayor Lowell Richards dismissed $1,080 in parking tickets for three children of Thomas McGee, the speaker of the Massachusetts House of Representatives. . . .

Lameduck Mayor Kevin White was lambasted when he declared that he saw nothing wrong with providing "preferential treatment" to powerful political figures who help Boston. Said White: "I do favors if I think it's in the best interests of the city."

—*Time*, Aug. 15, 1983

Taking a byte out of privacy

Early next month, almost any information ever collected by Alexandria [Virginia] agencies on the city's 30,000 homes, businesses and public buildings will be available to city officials at the touch of a keyboard.

—*Washington Post*, Aug. 22, 1983

Running government like a business—Boeing

Just behind the cockpit in the world's most sophisticated radar plane, on the leg of a folding blue-and-gray stool, sits the world's most expensive plastic cap.

What distinguishes this particular cap from any other lump of white nylon is that the Air Force paid its government supplier $1,118.26 for it, which is roughly the cost of the plastic, plus $1,118. . . .

In a 1981 cost breakdown routinely prepared for DISC (Defense Industrial Supply Center), when DISC first ordered the spares, Boeing said each stool cap began with 26 cents worth of plastic.

To make three caps, according to this document, Boeing required 66.71 labor hours, including 8.01 hours for "inspection," at a cost of $833.49. "Fringe benefits" for those labor hours amounted to $354.23. "Manufacturer's overhead," again on those labor hours, came in at $1,376.83.

After various other charges, Boeing added a "profit fee" of $358.65, or $119.55 per plastic cap.

Final cost, for three caps: $2,749.65, or $916.55 each. Internal Defense Department surcharges brought the unit cost to $1,118.26 for anyone buying the stool cap from DISC. . . .

A DISC spokesman, in a prepared statement, defended the company: "Rates contained in the Boeing cost breakdown were consistent with approved rates."

—*Washington Post*, Aug. 21, 1983

Where is Anne Gorsuch now that we need her?

Oak Ridge [Tennessee] has become a symbol of what many consider the nation's most disturbing hazardous waste problem: the enormous amount of waste generated and dumped by the federal government, much of it at sites which, ostensibly for reasons of national security, operate beyond the reach of the law and out of the sight of state inspectors.

—*Washington Post*, Aug. 17, 1983

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