

Does Growth Cause Inflation?

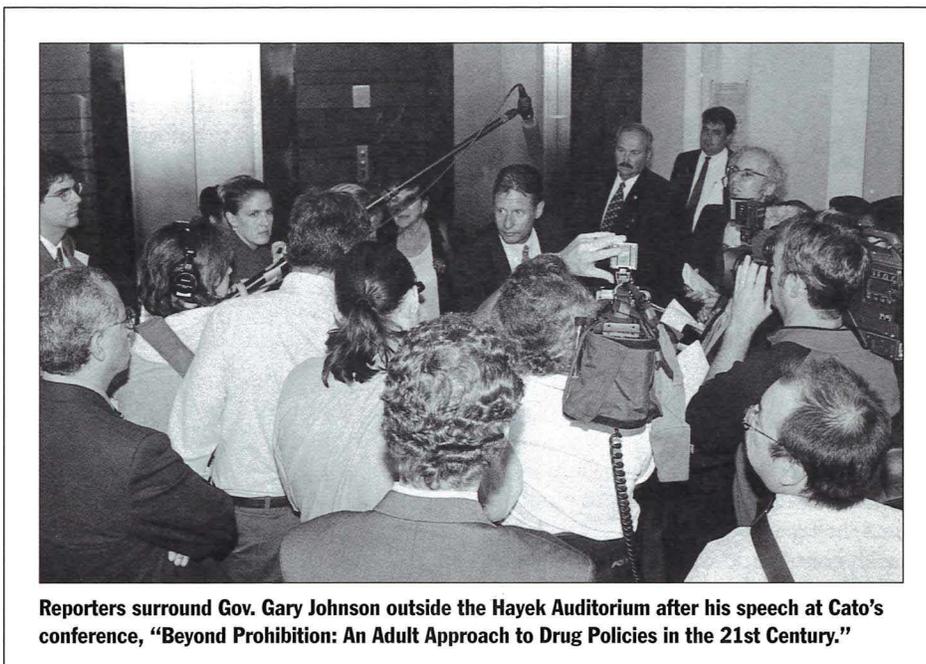
by David R. Henderson

For the last few years, the claim that an increase in economic growth leads to an increase in inflation and that decreased growth reduces inflation has been a mantra. That is the conventional wisdom in Washington and, to a lesser extent, on Wall Street. On October 12, for example, Federal Reserve Board governor Laurence Meyer stated, "Tightening monetary policy slows spending growth, opens up some slack temporarily in labor and product markets, and allows the slack to reduce inflation." Yet, taken literally, that claim cannot be true. All other things being equal, an increase in economic growth must cause inflation to drop.

Here's why. The seat-of-the-pants explanation of inflation is that it is caused by too much money "chasing" too few goods. It follows that the more goods that are produced, the lower the prices of goods. This connection between the level of production and the level of prices also holds for the rate of change of production (that is, the rate of economic growth) and the rate of change of prices (that is, the inflation rate).

Some simple arithmetic will help clarify. Start with the famous equation of exchange, $MV = PQ$, where M is the money supply; V is the velocity of money, that is, the speed at which money circulates; P is the price level; and q is the real output of the economy. If the growth rate of the economy increases, that is, if the growth rate of q increases, then, if the growth rates of M and V are held constant, the growth rate of the price level must fall. Since the growth rate of the price level

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Reporters surround Gov. Gary Johnson outside the Hayek Auditorium after his speech at Cato's conference, "Beyond Prohibition: An Adult Approach to Drug Policies in the 21st Century."

is just another term for the inflation rate, the inflation rate must fall. An increase in the rate of economic growth means more goods for money to "chase," which puts downward pressure on the inflation rate. Assume, for illustrative purposes, that the money supply grows at 6 percent a year and velocity is constant. Then, if annual economic growth is 3 percent, inflation must be 3 percent. (Actually, inflation must be 2.9 percent, which is approximately 3 percent). If, however, economic growth rises to 4 percent, inflation falls to 2 percent. (Actually, it falls to 1.9 percent.)

That higher economic growth must reduce inflation is straightforward. Why, then, does a man as brilliant as Federal Reserve chairman Alan Greenspan not get it? Actually, he does. He just never says things simply and straightforwardly when he can be complicated and obtuse instead. In 1995 Chairman Greenspan testified before the Senate Committee on Finance: "One factor in judging

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The Fraud of Campaign Finance Reform



You might not think that a cartoon would have much to do with so-called campaign finance reform, but I believe it is illustrative of the problematic nature of the proposed reforms. Garry Trudeau is a liberal who draws the usually clever cartoon strip *Doonesbury*. It is carried in more than 600 newspapers throughout the nation and is so popular that, when most papers downsized their comic strips in order to run more of them, Trudeau said, "Not with *Doonesbury* you don't." And so in more than 600 newspapers all the other cartoon strips are

smaller than Trudeau's strip.

This year Trudeau has frequently used his strip to criticize the presidential candidacies of George W. Bush and Steve Forbes. Bush is shown as a cowboy hat over a floating feather (the latter being how Trudeau used to depict Dan Quayle)—the candidate as a lightweight. Forbes is mocked for his inherited wealth and stiff persona.

Now, if you or I were to purchase advertising space equivalent to the space taken up by *Doonesbury* in those 600 newspapers, it would cost us hundreds of thousands of dollars. Each time. If we gave a candidate enough money to purchase that space, it would be against the law, violating the \$1,000 limit for such contributions. Indeed, it's interesting to note that if we agreed with Trudeau and wanted to buy space to reprint his strips attacking Forbes and Bush, that, too, would be against the law.

So, does that mean that a cartoonist has First Amendment rights the rest of us don't have? Apparently so. As does, for that matter, anyone who happens to work in the media. Rush Limbaugh's popular radio show allows him to lavish hundreds of thousands, even millions, of dollars of favorable or unfavorable publicity on any federal candidate he chooses. The same for newspaper editors who endorse candidates or television producers who slant their news coverage to reflect their political orientation.

Is it wrong that the media have this ability? Absolutely not. Vigorous, open political debate is essential to a free society. The problem is, not that the media have those rights, but that the rest of us don't. After all, the Founders pledged their "lives, fortunes, and sacred honor" to the Revolution. They didn't say "lives and fortunes up to \$1,000."

This is not a frivolous point. For if Jefferson was right that "eternal vigilance is the price of liberty," then the revolution is ongoing. Having politicians tell us how much we can spend to promote our political views was a mistake from the beginning and hardly consistent with the spirit of the American Revolution.

But that spirit has not been of much interest to America's political class during the 20th century. Their interest is in preserving their power, not preserving our liberties. In fact, the reason we should abolish contribution limits on federal campaigns, quite aside from the basic issue of liberty, is that the political class fears nothing more

than a well-funded challenger.

Without contribution limits, the quality of those challengers would soar—no more Michael Huffingtons, but serious candidates. Under the current system you either have to be a full-time professional politician or political activist with name recognition to have a chance, or be independently wealthy. But how many good candidates pass up a run for office because they lack the name recognition, don't have massive mailing lists from a lifetime in politics, and don't like grubbing for thousands of small contributions?

It is appalling that three of the major presidential candidates at this point—Al Gore, Bill Bradley, and John McCain—endorse "reforms" that tear at the very fabric of the First Amendment.

Money should be viewed as a proxy for information in political campaigns. When the political class insists there's too much money in politics, what they are really saying is that there is too much money they don't control in politics. After all, Proctor & Gamble spends more on advertising in the course of a year than all the federal election campaigns combined. Who is to say how much is too much?

As part of their campaign finance reform efforts, Senator McCain and his liberal Democratic colleague Sen. Russ Feingold have been adamant in their demands that Congress make it illegal for individuals or groups to purchase radio or television ads that use the name or likeness of a federal candidate. This, in the land of the free. Thus, Cato Board member Howie Rich, head of U.S. Term Limits,

would be committing a crime if he ran a TV ad stating, for instance, that George Nethercutt broke his word about serving no more than six years in the House of Representatives. The same would be true for tax, environmental, or any other groups attempting to inform the voters.

It's ironic that the biggest "special interest" of all in this debate is the media themselves. While they self-righteously condemn outside money in political campaigns, it is they (along with incumbents) who would benefit most from the restrictions. They become even more powerful gatekeepers of information going to the public. The media and the political class favor campaign finance reform, not to clean up politics, but to stifle open, honest debate that would be out of their control.

My recommendation for those participating in the next round of attacks on the First Amendment is to contemplate these sage words from the Supreme Court's decision in *Buckley v. Valeo*: "The First Amendment denies government the power to determine that spending to promote one's political views is wasteful, excessive, or unwise. In the free society ordained by our Constitution it is not the government, but the people—individually as citizens and candidates and collectively as associations and political committees—who must retain control over the quantity and range of debate on public issues in a political campaign." It's that simple. And that important.

“The political class fears nothing more than a well-funded challenger.”

—Edward H. Crane

Martin Lee: Hong Kong is losing its freedoms

The PRC at 50: China's Future Examined

As the People's Republic of China celebrated its 50th anniversary, experts from across the United States and Asia gathered at the Cato Institute's F. A. Hayek Auditorium on September 29 to discuss relations between the two countries.

In a poignant luncheon address, Hong Kong's democratic leader Martin Lee warned that "Hong Kong is beginning to lose its freedoms," political, economic, and religious. Lee, chairman of the Democratic Party in Hong Kong, described the awarding of the Cyberport contract to Li Ka-shing's business interests without competitive bidding as "cronyism" and saw the refusal by China of the Pope's proposed visit to Hong Kong as the first step in the curb of religious freedom. Lee said that the rule of law in Hong Kong "is going downhill and that the Chinese crackdown on the Falun Gong will spread to other groups in China, including the practice of Tai Chi." (Excerpts from Lee's remarks are on the September edition of CatoAudio.)

James R. Lilley, former U.S. ambassador to the People's Republic of China, delivered the keynote address. Lilley contended that one key to improving relations with China would be American support of China's accession to the World Trade Organization this year. "That would be a testament to the fact that we have recovered a sensible and pragmatic approach to China," Lilley said, adding that it would be a signal to the Chinese that Washington was serious.

The first panel discussion covered the many domestic, economic, social, and political changes that have occurred in China since 1949. Kate Xiao Zhou of the University of Hawaii at Manoa argued that China has gone through a "spontaneous" civil rights movement in which the people have "followed no leaders and formulated no explicit credo or doctrine." William McGurn of the *Wall Street Journal* said that China has opened, not because its leaders want it to, but because modernization is necessary for the country to survive.

The second panel dealt with such issues as the PRC's claims to the South China Sea islands, relations with Japan and Taiwan, and relations with the United States. Ted Galen Carpenter, vice president for defense and foreign policy studies at Cato, noted that "Washington's policy toward [China] is increasingly notable for its lack of consistency and clarity. A struggle is now under way between those who want to perpetuate the cooperative U.S.-PRC relationship of the 1970s and 1980s and those who see China as a repressive dictatorship and an emerging adversary of the United States and therefore favor a more hard-line approach in dealing with it." Selig Harrison, a senior scholar at the

have seriously eroded the broad social base of the CCP. This change has come about, ironically, precisely because of the relative success of the economic reform under Deng Xiaoping," Pei said. University of Pittsburgh professor Thomas Rawski argued that China isn't a market economy yet and that the lack of market mechanisms for investment means that China will have trouble rekindling high-speed growth without major policy shifts.

Hong Kong University professor David Li said that reformers in China at times are obsessed with short-term issues when they should be pushing for long-term reforms.

Trade, security, and human rights were the themes of panel four. The key issues were WTO membership



Hong Kong democratic leader Martin Lee



Mao Yushi listens as Kate Xiao Zhou discusses China's bottom-up reforms at Cato's conference on the 50th anniversary of the People's Republic of China.

Woodrow Wilson International Center, contended that "China's conventional force posture and nuclear weapons deployments are defensive in character and are likely to remain so in the absence of grave provocation."

Panel three focused on the political and economic reforms that are still needed if China is to become a prosperous democratic country in the first decades of the 21st century. Minxin Pei, senior associate at the Carnegie Endowment for International Peace, argued that while the Chinese Communist Party is celebrating 50 years of socialist control, it must thank market reforms for its continued survival. "Pro-market reforms

for the PRC, whether the trade deficit should be a matter of concern, whether trade should be linked to improvements in Beijing's human rights record, and whether tighter export controls are needed for national security reasons. Jim Dorn, vice president for academic affairs at Cato, argued that China needs a "constitution of liberty" to provide citizens protection from the government. Robert Manning of the Council on Foreign Relations argued that we must recognize China as an "ambiguous situation," not as the evil replacement of the USSR or as an ally. University of California at San Diego professor Barry Naughton contended that the economy has globalized to the point that Americans shouldn't worry about trade deficits with China or any other country.

The papers presented at "Whither China? The PRC at 50" will be published as a book early next year. In addition, the conference, broadcast live on the World Wide Web, can be viewed online or downloaded for viewing later at www.cato.org/realaudio/audiopages.html. ■

Voters want Social Security privatization

Education Reform, Test Ban Treaty Debated

◆**August 1-7:** As part of its Cato University program, the Cato Institute sponsored a seminar at the elegant Rancho Bernardo Inn near San Diego. Faculty at Cato University included Alan Charles Kors, Randy Barnett, Don Boudreaux, Paula Baker, and Tom G. Palmer. Guest lecturers included psychologist Nathaniel Branden and philosopher Christina Hoff Sommers. Cato's Edward H. Crane, David Boaz, Ted Galen Carpenter, and Robert A. Levy also spoke. More than 200 people attended.

◆**August 14:** The Cato Institute's Project on Social Security Privatization held a special Forum, "The Future of Social Security," in Ames, Iowa, hours before the state Republican Party's nonbinding presidential preference straw poll opened. Presidential candidates Steve Forbes and Alan Keyes accepted invitations to exchange ideas about Social Security. Other speakers included Michael Tanner, director of health and welfare studies at Cato; Lisa Davis of the National Committee to Preserve Social Security and Medicare; Jim Hutter of Iowa State University; and Scott Hodge of Citizens for a Sound Economy.

◆**September 9:** The Cato Institute hosted a Capitol Hill Policy Forum, "Social Security and the American Voter," to discuss the findings of a new nationwide poll conducted for Cato by Zogby International. John

Zogby, president of Zogby International, announced that, by a margin of 54.9 to 31.4 percent, Americans prefer changing the Social Security system to allow people the choice of putting their payroll taxes in individual accounts similar to individual retirement accounts or 401(k) plans. Michael Tanner, director of health and welfare studies at Cato, and Rep. Mark Sanford (R-S.C.) commented.

◆**September 12:** Ed and Kristina Crane hosted the 15th annual **Salmonfest** at their home. More than 500 friends of Cato attended.

◆**September 13:** Martin Gross discussed his book *The Conspiracy of Ignorance* at a Cato Institute Book Forum. Gross examined the educational abuse that is wrecking the chances of many youngsters for future learning. Cato executive vice president David Boaz contended that many problems in American schools are caused by a monopoly with captive customers.

◆**September 14:** The Cato Institute hosted a City Seminar, **Liberty in the New Millennium**, in Philadelphia. The speakers included syndicated columnist Robert Novak and Cato's Edward H. Crane, Jerry Taylor, Michael Tanner, and Robert A. Levy.

◆**September 15:** The Cato Institute held a screening of the film *Waco: The Rules*

of *Engagement*. The film, nominated last year for an Academy Award for "Best Documentary," presents evidence that the Federal Bureau of Investigation and the Bureau of Alcohol, Tobacco and Firearms illegally used lethal force in their raid on the Branch Davidian compound near Waco, Texas. In a panel discussion about the ongoing investigation, Rep. Bob Barr (R-Ga.) and David Kopel, Cato associate policy analyst and coauthor of *No More Wacos*, said that it is important to the rule of law that the government answer troubling questions and be held accountable for what happened in Waco. David Thibodeau, a Branch Davidian survivor and author of *A Place Called Waco*, spoke about the circumstances leading up to the final battle.

◆**September 16:** At the Cato Institute Policy Forum "The Comprehensive Test Ban Treaty: Thumbs Up or Thumbs Down?" Steven P. Andreasen of the National Security Council defended the Clinton administration's decision to ratify the CTBT—an international treaty that prohibits all explosive tests of nuclear weapons. Andreasen said that it is possible to have "zero-yield" because the technologies for verifying nuclear stockpiles have evolved. Marshall S. Billingslea of the Senate Foreign Relations Committee argued that the CTBT "was not carefully negotiated" and is more about creating an arms control legacy for

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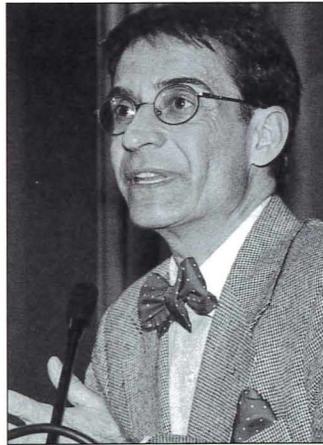


Presidential candidates Steve Forbes and Alan Keyes discuss Social Security reform at Cato's Ames, Iowa, seminar before the Iowa Republican straw poll.



At Cato's Capitol Hill forum, pollster John Zogby releases results showing that 55 percent of Americans support private retirement accounts.

Baltimore Sun reporter Lyle Denniston and University of Illinois law professor Robert Rotunda examine the Supreme Court's recent decisions on federalism.



Michael Tanner, Grace-Marie Arnett (standing), Eugene Steuerle, and Robert Helms discuss health care reform at a Cato Book Forum.

the Clinton administration than about making America more secure.

◆**September 17:** On the 212th anniversary of the Constitutional Convention's passage of the Constitution, the Cato Institute hosted a Policy Forum, "The Court Rediscovered Federalism." After decades of ignoring the principles of federalism, the Supreme Court handed down on the final day of its last term a number of opinions that move toward restoring the constitutional balance among states, individuals, and the federal government. Ronald D. Rotunda of the University of Illinois College of Law examined the historical move away from federalism and the recent cases. Lyle Denniston, Supreme Court correspondent for the *Baltimore Sun*, discussed some of the implications of the new federalism for Congress.

◆**September 22:** Contributors to *Empowering Health Care Consumers through Tax Reform* discussed their contributions at a Cato Book Forum. The speakers included Michael Tanner, director of health and welfare studies at Cato; Robert B. Helms of the American Enterprise Institute; economist C. Eugene Steuerle of the Urban Institute; Robert E. Moffit of the Heritage Foundation; and Grace Marie Arnett, president of the Galen Institute.

◆**September 23–26:** The Cato Institute hosted its annual Cato Club 200 retreat in Carefree, Arizona. Speakers included Frederick W. Smith, chairman of FDX Corporation; Richard Epstein of the University of Chicago School of Law; and syndicated columnist Arianna Huffington. Cato's Solveig Singleton, Stephen Moore, Michael Tanner, Jerry Taylor, and Robert A. Levy also spoke.

◆**September 29:** Experts from across the United States and Asia gathered at the Cato Institute's conference "Whither China? The PRC at 50" to discuss future relations between America and the People's Republic of China. James R. Lilley, former U.S. ambassador to the PRC, gave the conference's keynote address, and Martin Lee, chairman of the Democratic Party of Hong Kong, gave the luncheon address. The conference was organized by Cato's James A. Dorn and Ted Galen Carpenter. Speakers included Mao Yushi, director of the Unirule Institute in Beijing; Liu Junning of the Chinese Academy of Social Sciences; David Li of Hong Kong University of Science and Technology; and Robert Manning of the Council on Foreign Relations. ■

The Emergence of Liberalism in Modern China

On the eve of the 50th anniversary of the People's Republic of China, the Cato Institute held a conference in Washington, "Whither China? The PRC at 50." Among the speakers were Liu Junning of the Chinese Academy of Sciences; Martin Lee, chairman of the Democratic Party of Hong Kong; and James R. Lilley, former U.S. ambassador to China.

Liu Junning: Liberalism is enjoying a rebirth in China's intellectual circles. As *Newsweek* recently reported, liberal economists are "hot" in China. In particular, there has been a lot of attention focused on the ideas of the late Friedrich Hayek. Even the prime minister of China has Hayek's works on his bookshelf.

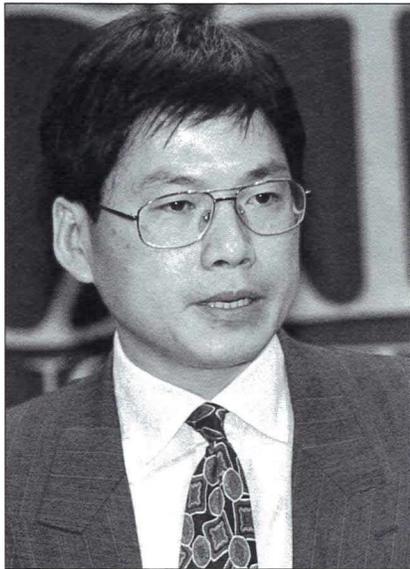
Interest in liberalism in China isn't completely unprecedented. Before the communist triumph in 1949, there were some liberal intellectuals caught between the authoritarian Nationalist Party and the rising totalitarian Communist Party. Liberal ideas and intellectuals were completely rooted out in the anti-rightist movement in 1957, at the same time private property rights were outlawed, free enterprise was abolished, and a command economy was established.

A lot of subtle yet visible changes have led to the reemergence of liberalism in China. The country is shifting from a planned command economy to a heavily state-regulated market economy. The change from a Leninist political system to some form of one-party authoritarianism has been key. The middle class is growing, and China has a nascent civil society.

The old ideology has failed, and the attendant "right to rule" has lost almost all of its "true believers." Some observers may wonder how liberalism will be able to sprout and grow in Red China. The answer lies in the market economy or, as Adam Smith called

it, "the system of natural liberty."

Market mechanisms in China promote not only greater economic freedom but other freedoms as well, such as freedom of speech. Ever since the Chinese government stopped giving subsidies to most newspapers, magazines, and TV stations after the introduction of market-oriented reforms, the media have been publishing things to keep the interest of their readers. Since more and more people in China are interested in liberal ideas, the editors have been very enthusiastic in meeting the demand, despite harassment and threats of censorship. Some of them started



Liu Junning: "Even the prime minister of China has Hayek's works on his bookshelf."

to stop censoring themselves—not just for economic survival but also because many of them are becoming genuinely attracted to liberalism. Now it is the editors who are pushing the intellectuals. In China the only effective way to stop the trend of liberalization is for the government to resume media subsidies, which it now lacks the means to do.

The political culture of China is shifting in a liberal direction. Gone are the days when you could be proud to be a leftist. Now intellectuals prefer to be identified with liberalism. In today's China almost all of the opinion leaders and celebrities in leading fields are liberals.

One special factor that is contributing greatly to the spread of liberal ideas in China merits special emphasis: the Internet. China now is making a great leap into the "information age" and a "network society." Internet use is rapidly growing in China, particularly at universities and academic institutions. In 1997 there were about 640,000 Internet users in China. There are now more than 4 million. The China Internet Information Center estimates that the number of Internet users will soon rise to 7 million. With the prices of personal computers falling and Internet access increasing, it is estimated that

there will be more than 33 million Internet users by the year 2003.

Obstacles do remain. Liberalism in China has never been well developed or localized, and therefore has failed to dominate the political agenda for most of China's torturous modern history.

But there is reason to be optimistic. The opening of China in the reform period, the experience of the 1989 movement, the collapse of the world communist camp, and the great expansion of the global market have all provided favorable conditions for democratization and liberalization in China.

Liberals are trying to shape the direction of political reform in China: increasing individual freedom and securing property rights, strengthening legislative bodies, placing the military and police more firmly under civilian control, relaxing the controls over non-governmental organizations, strengthening the judiciary, and granting the populace more meaningful avenues of political participation.

This conference has raised a very important question: Whither China? Will it be a potential threat or a constructive partner? A liberal China can be a constructive partner for the United States; a nationalistic and authoritarian China, a potential rival. If it is true that liberal democracies won't fight against one another, then the future role of China in the world and China's relations with the West are very closely intertwined with liberalization and democratization. So it is in the greatest interests of the established democracies to encourage the emerging liberal enterprise in China as a driving force in making it a new democracy based on liberalism.

Martin Lee: This is the 50th birthday of the People's Republic of China. In 1949 two boys were taken by their respective fathers to Hong Kong. One boy was 11 and the other was 12. I was the younger one. The slightly older guy, Tung Chee Hwa, is now the chief executive of Hong Kong. If you ask people in Hong Kong why they are living and working there instead of in China, they will probably tell you about the very important decision that their father, grandfather, or great-grandfather made decades ago—to take the entire family to Hong Kong.

Why? To be free. They couldn't have gone

“Gone are the days when you could be proud to be a leftist. Now China’s intellectuals prefer to be identified with liberalism.”

for wealth, because Hong Kong then was very poor. People went there because they wanted to be free. And that is why so many left Hong Kong before the handover in 1997.

Freedom is what gives luster to this pearl of the Orient. It is a pity, but we must distinguish between political and economic freedoms in China. In fact, you either have freedom or you don't. But in China they separate the two. They will allow people to enjoy economic freedoms but not political freedoms. How long can that last? How can you allow the economic half of the genie to come out of the bottle but keep the political half inside?

In Hong Kong, unfortunately, we are beginning to lose our freedoms, both political and economic. China has always wanted to control the goose that lays the golden eggs. China was already setting up institutions of control before the British left. Our constitution, the Basic Law, of which I was one of the drafters, was promulgated in April 1990. It is not a very good constitution, I'm afraid, because it is very restrictive. China was able to control the executive through her own appointed chief executive, Mr. Tung, the 12-year-old boy who with his father left China for Hong Kong in 1949.

In January 1999 the court of final approval laid down a landmark decision, dictating to courts in Hong Kong how they should construe our constitution. The Hong Kong court had construed certain articles of the Basic Law as giving the court the power to refuse to accept the government's submissions. The government then went to Beijing and effectively had that interpretation overturned by the standing committee of the National People's Congress. That sent the following message to the world: "If you should be unfortunate enough to be involved in litigation with the Hong Kong government, and if you should lose in the court of final appeal, then that is indeed final for you. But if you should win in the court of final appeal, don't jump for joy yet because the decision is only semifinal and China could later overturn it."

The decision of the court of final approval also sent the following message to the judges in Hong Kong: "You naughty boys. You

knew what we wanted from you and you didn't deliver. So we'll have to correct you. You can rule as you like in the future, but we'll correct you if we wish to do so." The time, I'm afraid, will soon come when those judges will begin to ask themselves if they are doing the people of Hong Kong a disservice by conforming to what China wants.

They will ask, "How should we rule when we know the government is wrong? Do we uphold the law according to our judicial oath and defend the rights and freedoms of our people? If we do that, what happens? How long will our decisions last? Two months?"



Martin Lee: "In Hong Kong, we are beginning to lose our freedoms, both political and economic."

Once the judges start asking themselves those questions, Hong Kong will be no different from China or Singapore. In those countries, the government always wins.

As for economic freedoms, here is one of several recent cases. The director of public prosecutions agreed that a publishing tycoon and four of her senior executives caught conspiring should be prosecuted. But the secretary for justice, the equivalent of the U.S. attorney general, decided to prosecute everyone but the boss. The reason? If the boss had been prosecuted, 2,000 people might have lost their jobs. Which means that if any businessman in Hong Kong who employs only 20 or 200 people gets into trouble with the criminal law, he will be prosecuted. But if he has 2,000 or more employees, then he is innocent. That rich lady also happened to be a long-time family friend of the chief executive. Cronyism has already crept in. For years

I've been saying that if we in Hong Kong cannot export our rule of law to China, it will export its corruption and cronyism to Hong Kong.

One country, two systems was the brainchild of Deng Xiaoping. He wanted to be the leader who won Hong Kong back from the British and Macao back from Portuguese rule. He wanted to be the one to wipe away the shame of the opium war. But he didn't want to drag Hong Kong down while China was still developing. You keep your way of life, your rule of law, your level playing field, and your freedoms, he said. But that's difficult to implement. They have 1.2 billion people; we have only 6.5 million. Do you remember your childhood days when you used to play on the see-saw? Imagine yourself now playing that game with a small child. How can you play in that situation? You must move toward the center until an equilibrium is struck. The Chinese government should do something similar by allowing everyone in Hong Kong, in particular the Hong Kong government servants, to maintain the highest degree of autonomy permitted under the joint declaration and the Basic Law. But that's not happening. The Chinese leaders are not moving to strike an equilibrium.

What is the way forward for China? On the one hand China wants control, and on the other hand it wants to be prosperous. So you have the troops stationed in Beijing and the business people celebrating in Shanghai. You need a psychiatrist to get the right balance.

Chinese leaders should look at Taiwan. Just a decade ago Chinese people in Taiwan were just as oppressed by the Kuomintang as were their counterparts in China. In both places dissidents were either thrown into prison or driven overseas. (Most of them have landed in the United States.) But look at Taiwan today. There are democratic elections. There still isn't the rule of law in Taiwan, but the people are free and prosperous. The Kuomintang is still in charge, although it must work very hard to win elections. Why can't the leaders in China do the same? Why don't they look at Hong Kong where we still

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“My teacher asked if anyone knew what *laissez faire* meant. I thought it meant the government was ‘lazy’ and ‘fair.’ And it certainly worked well for Hong Kong.”

CHINA *Continued from page 7*

have a pretty good system of law, although it is beginning to go downhill? It must be much easier to keep what you have than to develop what you don't have. We would be able to provide a shining example for a capitalist China—what they call “socialism with Chinese characteristics.” You may as well call it capitalism with some degree of government control. We used to be a very corrupt city, but now corruption is well under control. The Chinese leaders have been talking about the rule of law. They know, however, that to implement it would mean that all the leaders, without exception, would have to comply with the law.

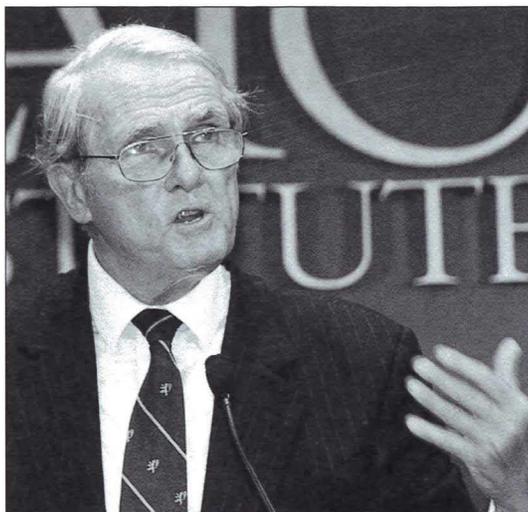
I was surprised to read today that Hong Kong's chief secretary, Anson Chang, said that Hong Kong never had a *laissez faire* policy. For years the Hong Kong government's interpretation of the French phrase *laissez faire* was “positive nonintervention.” It takes a while to work out what that means. I remember that when I was a boy my teacher asked if anybody knew what *laissez faire* meant. I didn't realize it was a French phrase. I thought it meant the government was “lazy” and “fair.” And it certainly worked well for Hong Kong under British rule.

What do I feel as a Chinese person as my country turns 50? I wish I could be happy. But I have not been invited to Beijing to celebrate. They will not allow me in. Not only me. Practically all of the popularly elected legislators are not allowed in. I don't think I'm missing too much. I just read that half a million people selected by the government to celebrate in Tiananmen Square have been provided with adult nappies to answer the call of nature. The officials don't want to bring in those unsightly temporary toilets. Well, if that is true, then I'm happy not to have been invited.

Looking at my country, I see that it is strong, much stronger than before. But am I really proud of my country? I will be when I know that the rights of every citizen in China are respected and protected by law. That will come. The whole world is marching toward democracy, freedom, human rights, and the rule of law. The Chinese leaders cannot block that tide for long.

A few days ago I was having dinner with a good friend, and at the end he said, “Let's have a toast. What shall it be, Martin?” I said, “Let's drink to democracy and freedom in China.” To which he added, “In the next millennium.”

James R. Lilley: A fairly convincing case can be made that the partnership between China and Taiwan is moving in the right direc-



James Lilley: “China and Taiwan must enter the World Trade Organization almost simultaneously and deal with each other as equals.”

tion. Taiwan and China actually come very close to being partners economically, in reality if not in rhetoric. Since 1987, there has been a tremendous amount of trade and investment between the two nations. There are everyday examples of pragmatism beating out political differences. One incident that doesn't attract much attention was Taiwan's decision in August 1999 to adopt the Chinese romanization of the Mandarin Chinese dialect. Business is now often done on the Internet. Taiwanese companies want to dominate the Asian portion of the Internet; they can do so only by using the Chinese romanization. Such practical needs are a good way to improve relations in the long term.

Beijing's recalcitrance in its dealings with Taiwan must be viewed against a backdrop of thousands of deals and exchanges at the highest level between China's political leaders and Taiwanese businessmen. Douglas Chu of Taiwan's Far Eastern Textiles best

sums this up: “I'm an industrialist. I have enough problems building plants; I should not be worried about missiles back and forth. This is a cloud; if it stays there, China will pay a price.” He's right. Taiwanese investment in China went down 30 percent in the first half of 1999, whereas it went up 10 percent elsewhere.

We must acknowledge, however, that Taiwan has been a flash point for much of this century. But we must see that, despite the dangers, Taiwan is not Kosovo, Kashmir, or Korea. Rhetoric has often crowded out reality. Mao Tse-Tung, for instance, is quoted as having said to an American leader, “100 years for Taiwan to unify.” Chinese leaders today say their policy has changed. Now they expect unification to take 87 years.

At a recent meeting in Washington, a well-known U.S. strategist on China talked about a preemptive strike that China might take against Taiwan. I asked a Chinese military officer there what he thought about that. He dismissed what the strategist said: “We are not suicidal.”

We can keep Taiwan a flash point—with bungling on our side, provocation on Taiwan's side, and overreaction on China's side. One thing the United States must realize is that China and Taiwan must enter the World Trade Organization almost simultaneously and deal with each other as equals in that organization. We need to handle Taiwan with skill and not with condescension because we know that when you mess up your Taiwan policy, your China policy is affected and when you get the Taiwan policy right and the China policy right, the situation moves ahead as it did in 1987. Yes, we can influence what people do, but it's a sort of poker game. I have a sense of optimism because I've looked at the complexities and expansion of the Chinese-Taiwanese ties. It seems to me that we are moving away from the sterile arguments about theater missile defense versus missile deployments and getting to work on issues where the stakes are really very high: North Korea. We can get through this with the United States taking the lead in establishing a peaceful and prosperous environment in the 21st century. ■

Antidumping laws can't be justified

Microsoft Finds Itself in "Orwellian World"

The antitrust case brought by the U.S. Department of Justice against Microsoft is "the most important and manifestly the least justified antitrust crusade of our generation," writes Robert A. Levy in "Microsoft Redux: Anatomy of a Baseless Lawsuit" (Policy Analysis no. 352). In examining the DOJ's twisted logic, Levy points out that we have entered "the post-modern world of high-tech antitrust where big is once again bad, lofty profit margins are a wake-up call to government regulators, executives are brought to heel for aggressively worded e-mails, pricing too high is monopolistic, pricing too low is predatory, propping up politically wired competitors is the surreptitious aim, bundling products that consumers want is illegal, and successful companies are rewarded by dismemberment. That's the Orwellian world in which Microsoft finds itself." The fundamental questions that must be asked in the case against Microsoft, Levy says, are "whether Microsoft has a monopoly, whether it's misusing its market power, and whether government can find a cure that isn't worse than the disease. The answers are no, no, no." Levy, senior fellow in constitutional studies at Cato, points out that "the market moves faster than antitrust could ever move. The assumption of would-be regulators—that inefficiencies, especially in high-tech markets, can lock a company into a position from which it can't be unseated—is a complete myth. Consumers rule, not producers." Microsoft faces stiff competition on many fronts, especially from Web-based software, which has already overlaid, and may eventually displace, major parts of Windows. "Microsoft has zero leverage in a world where applications are written so that any browser can run them and any operating system can access them," Levy notes.

◆Workers Should Welcome Imports

Imports pose little risk to job security for U.S. workers, writes Dan Griswold in the new Cato Institute study "Trade, Jobs, and Manufacturing: Why (Almost All) U.S. Workers Should Welcome Imports" (Trade Briefing Paper no. 6). Griswold, associate director of Cato's Center for Trade Policy Studies, debunks claims about how workers are threatened by trade, pointing out that "the vast majority

of Americans work in sectors of the economy that do not face significant import competition." Griswold finds that trade is not the most significant cause of job displacement. "Technology and other nontrade factors account for most workers displaced from their jobs each year," Griswold writes. He concludes by warning that "presidential and congressional candidates who talk about 'saving jobs' by raising barriers to free trade are really talking about dragging down the real incomes of the vast majority of Americans for the temporary benefit of a small fraction of American workers."

◆Chile's Private Pension System Turns 18

Chile's privatized pension system is "an astounding success," notes L. Jacobo Rodríguez in "Chile's Private Pension System at 18: Its Current State and Future Challenges" (Social Security Paper no. 17). Established in 1981 to replace the government-run pay-as-you-go retirement program, Chile's private system "has allowed workers to retire with better and more secure pensions" and enjoy an average real rate of return of approximately 11.3 percent per year. More than 95 percent of Chilean workers have their own pension savings accounts. The new system has allowed Chile and other Latin American countries that have followed the Chilean example to defuse the "fiscal time bomb"

that is ticking for countries with pay-as-you-go systems, as fewer and fewer workers have to pay for the retirement benefits of more and more retirees. Rodríguez traces the development and the implementation of the current private system and examines complaints from some U.S. critics who argue, among other things, that the system's administrative costs are high. The study recommends changes that would improve the performance of Chile's system, including steps to liberalize the commission structure, allow banks and other financial institutions to enter the industry, and let pension fund management companies manage more than one fund.

◆Antidumping Law: Rhetoric versus Reality

The U.S. antidumping law "all too frequently punishes normal marketplace behavior that has nothing to do with 'unfair trade' under any plausible definition of that term," according to "The U.S. Antidumping Law: Rhetoric versus Reality" (Trade Policy Analysis no. 7). Brink Lindsey, director of Cato's Center for Trade Policy Studies, argues that the current law "does not reliably identify either price discrimination or below-cost sales." Lindsey reviewed all Department of Commerce final determinations through the end of 1998 in original antidumping investigations initiated since January 1,

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Pilon Discusses Constitution in *Cato's Letters*

The latest in the *Cato's Letters* series (no. 13) is an essay by Roger Pilon, Cato's vice president for legal affairs, titled "The Purpose and Limits of Government." In it, Pilon discusses the moral, political, and legal theory behind the Declaration of Independence, then shows how that theory is reflected in the Constitution and how modern constitutional law has departed in major ways from the original design.

"The most cursory reading of the writings of the day makes it plain that the Founders intended nothing like our present American leviathan," Pilon writes, adding that "many of the grievances the Declaration lists, which led to our revolt, are today the ordinary stuff of government in America."

The *Cato's Letters* series features distinguished essays on political economy and public policy. The name *Cato's Letters* is taken from a series of early 18th-century essays on political liberty that played a major role in laying the philosophical foundation for the American Revolution.

"The Purpose and Limits of Government" can be purchased (paper, \$1.00) by calling 1-800-767-1241 or through the Cato Institute's online bookstore, www.cato.org.

STUDIES *Continued from page 9*

1995—a total of 141 company-specific dumping findings in 49 different cases. Lindsey says that the evidence shows clearly that “there is a disconnect between the rhetoric of antidumping supporters and the reality of antidumping practice.” Lindsey proposes specific reforms that would eliminate the worst abuses under the current law. In its present form, the antidumping law cannot be justified as ensuring a “level playing field” for American companies and their foreign competitors. “On the contrary,” Lindsey concludes, “the law actively discriminates against foreign goods by subjecting them to requirements not applicable to American products.”

◆Feeling a Draft?

Worry about recruitment and retention problems in the military has led to recent calls for a return to a draft. But Doug Bandow, senior fellow at the Cato Institute, concludes in a new Cato study that conscription not only would fail to improve retention of skilled personnel; it would be “unfair and unjust—sacrificing the very constitutional liberties that the military is charged to defend.” In “Fixing What Ain’t Broke: The Renewed Call for Conscription” (Policy Analysis no. 351), Bandow contends that although advocates of conscription have usually based their arguments for a draft on national survival, a draft “certainly isn’t needed now. The United States is at peace. No major war threatens. Washington stands astride the globe as a colossus—its enemies are pathetic and its allies are secure.” The military is having trouble retaining skilled soldiers, such as pilots and computer technicians, but a major reason for retention problems is that frequent and frivolous deployments are driving skilled personnel away. If the United States returned to a foreign policy “appropriate for a republic rather than an empire,” the All-Volunteer Force would have little difficulty attracting qualified soldiers and would save taxpayers some money as well, Bandow argues. The AVF “is providing the best military personnel that America has ever had, [and] for that reason, few leaders in the armed services would like to return to conscription,” Bandow explains.

◆Police or Paramilitaries?

“Over the past 20 years, Congress has encouraged the U.S. military to supply intelligence, equipment, and training to civilian police,” and the result has been the development of “a culture of militarism in American law enforcement,” writes Diane Cecilia Weber in “Warrior Cops: The Ominous Growth of Paramilitarism in American Police Departments” (Cato Briefing Paper no. 50). Weber notes that Congress opened the door to “a dramatic expansion of the role of the military in law enforcement activity” in 1981, when it passed the Military Cooperation with Law Enforcement Officials Act, which amended a post-Civil War law designed to keep military forces out of domestic law enforcement work and for the first time authorized the Pentagon to “assist” civilian police in enforcement of drug laws. Thus began a “dramatic expansion of the role of the military in law enforcement activity,” Weber reports. The Pentagon has been equipping police departments with M-16s, armored personnel carriers, and grenade launchers. In all, the Department of Defense issued 1.2 million pieces of military hardware to police departments between 1995 and 1997. Police paramilitary units train with active-duty Army Rangers and Navy SEALs. “The sharing of training and technology is producing a shared mindset,” Weber observes. “Confusing the police function with the military function can have dangerous consequences.”

◆Export Controls Can’t Stop Cryptography

Encryption technology, which allows people using electronic networks to ensure that the messages they send remain private, cannot—and should not—be controlled by government interference, writes Arnold G. Reinhold in a new Cato paper “Strong Cryptography: The Global Tide of Change” (Cato Briefing Paper no. 51). Reinhold, coauthor of the popular books *E-Mail for Dummies* and *The Internet for Dummies Quick Reference*, argues that “it is time to recognize the inevitability of strong, nonrecoverable cryptography and take steps to maximize that technology’s benefits to society and deal realistically with its less desirable attributes.” Reinhold notes that the government has long tried to control encryption technology to preserve its ability to intercept criminal

communications. “Such claims usually invoke a troika of evils—drug dealers, terrorists, and child pornographers—though decades of wiretapping have not halted those crimes,” he writes. But cryptographic technology simply cannot be stopped. “If any major governments, terrorist organizations, or drug cartels are not now using strong cryptography, it is not because of lack of availability or lack of reliable suppliers. There are many firms overseas that are willing to provide cryptographic software.”

◆Unintended Consequences of the Fed’s LTCM Bailout

The Federal Reserve’s bailout of Long-Term Capital Management, a well-known hedge fund, was misguided and unnecessary. The bailout set the stage for trouble in the future, writes Kevin Dowd in a Cato study published on the first anniversary of the bailout. In “Too Big to Fail: Long-Term Capital Management and the Federal Reserve” (Cato Briefing Paper no. 52), Dowd notes that although the intervention did prevent LTCM’s demise, there have been many unintended negative effects: “It implies a major open-ended extension of Federal Reserve responsibilities, without any congressional mandate; [and] it implies a return to the discredited doctrine that the Fed should prevent the failure of large financial firms, which encourages irresponsible risk taking.” Dowd, professor of economics at the University of Sheffield and adjunct scholar at the Cato Institute, argues that “letting LTCM fail might well have had a salutary effect on financial markets: it would have sent a strong and convincing signal that no financial firm—however big—could expect to be bailed out from the consequences of its own mismanagement.”

◆Aid to Dependent Weapons Manufacturers

U.S. weapons suppliers get \$7.9 billion a year in federal government subsidies that are tucked away in the defense and foreign aid budgets, notes William D. Hartung in a new Cato Institute study, “Corporate Welfare for Weapons Makers: The Hidden Costs of Spending on Defense and Foreign Aid” (Policy Analysis no. 350). This corporate welfare takes many forms, including “taxpayer-backed loans, grants, and government protocol activ-

200 hear Kors, Barnett, Branden

A Week at Cato University

ities that help U.S. weapons makers sell their products to foreign customers.” Hartung, a fellow at the World Policy Institute, argues that both political parties now appear ready to increase military spending in fiscal year 2000. But who will benefit? “Will it be the men and women of our armed forces, as President Clinton and Republican congressional leaders have claimed? Or will it be such weapons-making conglomerates as Raytheon, Boeing, and Lockheed Martin?” Corporate welfare for arms makers gets little public scrutiny because of the way it’s put in the budget, Hartung writes. “The U.S. government supplies arms export subsidies through various programs administered by separate agencies. Those subsidies are frequently listed under innocuous budget titles that don’t seem to have anything to do with weapons exports: excess defense articles, emergency drawdowns, and economic support funds, for example. That budgetary sleight of hand has made it difficult to keep track of U.S. arms export subsidies, much less reduce them.” In fact, he adds, of the \$7.9 billion in U.S. arms export subsidies, just \$1.2 billion comes from the Pentagon.

◆Bailing Out Creditors and Debtors Creates Economic Disorder

“A dysfunctional relationship has developed between lenders and borrowers in international finance,” and the International Monetary Fund is part of the problem, writes Ian Vásquez, director of the Cato Project on Global Economic Liberty, in “Repairing the Lender-Borrower Relationship in International Finance” (Foreign Policy Briefing no. 54). According to Vásquez, “Governments have gotten their countries into trouble with their creditors for hundreds of years, and periodic problems with paying back loans will surely continue to be a feature of global finance well into the future.” But he adds that current attempts to shield creditors and debtor nations from economic realities, largely the result of IMF efforts, create disorder and prolong the process of crisis resolution. Creditors should take losses during financial crises, and the IMF should not try to prevent countries from defaulting. Direct bargaining between creditors and debtors would reduce moral hazard and lead to faster debt renegotiations. ■

While many people took their summer vacations getting away from it all, more than 200 professionals, businesspeople, college students, and retirees spent a week in early August exploring the ideas of liberty at the Cato University Summer Seminar. Held August 1–7 at Rancho Bernardo Inn, about 20 miles from San Diego, the program featured lectures and discussions on American history, law, economics, psychology, philosophy, and public policy.

In announcing the August seminar, Cato University director Tom G. Palmer said, “This program gives you the chance to recapture the intense intellectual atmosphere of your college days, in a climate where the lecturers and other participants share your fundamental ideas about freedom and justice. The schedule of lectures and discussions is designed to impart a great deal of information and analysis and encourage spirited discussion about the implications of the basic ideas.”

The faculty included some of the country’s most spirited and brightest defenders of liberty. Alan Charles Kors, professor of history at the University of Pennsylvania and coauthor of *The Shadow University*, discussed the roots of liberty and the state of academia today. Randy Barnett, professor of law at Boston University and author of *The Structure of Liberty*, gave a sneak preview of his forthcoming book during his talk “The Constitutional Presumption of Liberty.” (Excerpts of Barnett’s remarks are available on the September edition of CatoAudio.) Don Boudreaux, president of the Foundation for Economic Education, discussed the economics of law and the illogic of politics. Historian Paula Baker of the University of Pittsburgh discussed the growth of the American welfare state and American liberty in the 19th and 20th centuries. Guest lecturers included psychologist Nathaniel Branden, author of *Taking Responsibility*, who examined liberty and

responsibility from a psychological viewpoint, and philosopher Christina Hoff Sommers, author of *Who Stole Feminism?* who discussed the way America has become “the republic of feelings.” Cato’s Edward H. Crane, David Boaz, Ted Galen Carpenter, Robert A. Levy, and Tom Palmer also spoke.

The attendees heaped glowing praise on the summer seminar. “The Cato University Summer Seminar was one of the most



Participants in Cato University question historian Alan Kors at an evening picnic.

intellectually exciting times of my life,” said Kyle Larsen of Valrico, Florida. “All of the speakers were engaging and entertaining, and the friendships I have built with some of the fellow participants have far outlasted the week of the conference.”

“Excellent organization and production,” said Lyn Weingarten of Austin, Texas. “Talks were the right length with plenty of time for clarification and discussion.”

“Overall we enjoyed the week immensely, felt uplifted and educated, and are mulling over how much we can increase our annual Cato donation,” said David and Shirley Gilbreath of St. George, Utah.

Scholarships from the Opportunity Foundation allowed 40 students to participate in the program.

The Cato University program also includes a separate 12-month home-study course that uses audiotapes, books, and an integrated study guide. Another weeklong seminar and a weekend seminar will be held in 2000. More information about Cato University is available on the Cato University Web site at <http://www.cato-university.org>. ■

“All other things being equal, an increase in economic growth must cause inflation to drop.”

INFLATION *Continued from page 1*

the inflationary risks in the economy is the potential for expansion of our productive capacity. If ‘potential GDP’ is growing rapidly, actual output can also continue to grow rapidly without intensifying pressures on resources.” Translation: if growth is higher, inflation is lower.

Can Productivity Grow?

Of course, it’s hard to know at any given time what the potential growth rate of an economy is. Various macro economists, especially those trained in the Keynesian tradition, may tell us that the upper limit on an economy’s long-term growth rate is 2 or 2.5 percent. But if you push them for their reasons, the best they can do is to tell you that the economy’s growth rate equals the sum of employment growth and productivity growth, that employment growth can’t be much more than 1 percent in the long run, and that productivity can’t be expected to grow by much more than about 1.25 percent a year. The first statement is necessarily true: an economy’s growth rate does equal the growth of employment plus the growth rate of output per worker (productivity). The second statement is probably true, but it depends on the unstated, and crucial, assumption that limits on immigration to the United States are not progressively relaxed: allowing the number of workers admitted into the United States to increase by a million a year, for example, would increase the U.S. labor force by about 0.8 percent.

The third statement is the most controversial. People who believe that productivity growth will be limited point to the past: between 1973 and 1993, for example, measured productivity—output per man-hour—in the United States increased by an annual average of 1.23 percent. But that past says little about the future. Even in the recent past, between 1993 and 1998, productivity growth averaged 1.46 percent, above what the “growth skeptics” thought was the upper limit. This higher productivity growth is one of the reasons that real gross domestic product has grown by an average of 3.4 percent, much higher than the 2 to 2.5 percent that was anticipated by the growth skeptics. (The other, more important reason for higher growth

is that employment grew by 2.56 percent a year between 1993 and 1998.)

There is strong reason to believe that productivity can grow by 1.5 to 2 percent a year. Analysts who have studied the information technology (IT) industries can point to many ways in which the Internet, computers, and software will be able to increase productivity further. Some have compared the role of the IT industries in the current U.S. economy to the economic role of electricity toward the end of the 19th century before electricity had been completely integrated into the economy. If they’re right, then we can expect an explosion of growth as the IT industries are further integrated into the economy. Moreover, exciting advances in biotechnology and artificial intelligence will likely lead to further productivity improvements over the next 10 to 20 years. Stock prices have risen greatly over the last 5 years because the market has increasingly come to anticipate large productivity increases, some of which will be captured by the firms that create them.

What Greenspan Can Know

Of course, I could be wrong about future growth and the growth skeptics could be right. Why does it matter? This gets us back to the connection between economic growth and inflation. The reason it matters to Greenspan is that it affects his decision and that of his colleagues on the Federal Open Market Committee about how quickly to increase the money supply. Greenspan has made clear that his main goal as Fed chairman is to prevent inflation from increasing and gradually bring it down to zero. In the 12 years of his chairmanship of the Federal Reserve, from 1987 to the present, inflation

has averaged 3.2 percent, and in the last 8 years it has averaged 2.6 percent. But because there is a lag in the effect of monetary policy on the economy, when Greenspan and the Fed control the growth of the money supply by buying and selling bonds, they affect only future inflation. That’s why Greenspan would like to know how fast the economy can grow. If the economy’s future growth rate is, say, one percentage point higher than previously thought, then, for a given inflation target, the Fed should buy bonds to increase the growth rate of the money supply by an additional percentage point. If, on the other hand, the economy’s future growth rate is one percentage point lower than previously thought, then the Fed should sell bonds to reduce the growth rate of the money supply by an additional percentage point. Unfortunately, no Federal Reserve chairman, no matter how brilliant, and no one else, for that matter, can know for certain the economy’s future growth rate. That’s why it makes sense for Federal Reserve officials to pay attention to indicators of future growth and of future inflation.

But what does not make sense is for the Federal Reserve chairman to pay much attention to three of the main economic variables that he talks about in his speeches and testimony: the recent inflation rate, the recent unemployment rate, and the recent economic growth rate. Those variables all have two big limitations. First, they are, necessarily, known only after the fact. The inflation rate and unemployment rate that are reported early every month are the rates for the previous month; the economic growth rate reported every three months is the government’s estimated growth rate for the previous quarter, and the government’s estimates are often wrong—sometimes wildly wrong. Second, the recent inflation rate, unemployment rate, and economic growth rate, to the extent they are affected by monetary policy, are the result of past monetary policy. They aren’t much help in figuring out how to run monetary policy now and in the future. What Greenspan and the Fed care about are the future values of those three variables, especially the inflation rate, and those values will be the result of recent and future monetary policy.

Consider a concrete example. Let’s say that, in a hypothetical October, the unemployment report from the federal govern-



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“Both the price of gold and the yield spread on bonds are the result of judgments about the future, not the past. They are far more valuable than knowledge of last month’s unemployment rate.”

ment’s Bureau of Labor Statistics shows that the unemployment rate fell from 4.5 to 4.2 percent in September and the Department of Commerce’s October report shows that during the summer quarter the annualized growth rate of real GDP rose from 2.5 to 3.2 percent. Most commentators, seeing those data, report that the economy is heating up. But they don’t know that. All they know is that the economy did heat up. The data reported tell them literally nothing about what the economy is doing now, let alone what it will do in the future. Moreover, to the extent the increase in growth and decrease in unemployment were due to monetary policy, the monetary policy that affected them was implemented sometime earlier in the year or even in the previous year.

Why, then, doesn’t the Federal Reserve chairman stop looking at those data and, instead, settle on a constant growth rate of the money supply, as monetarist Milton Friedman has recommended for decades? Friedman has argued that by causing the money supply to grow by, say, 3 percent a year, you can have zero inflation because the economy will grow by 2 to 3 percent a year, and the resulting inflation rate will be somewhere between zero and 1 percent. There are two main problems with a constant-money-supply-growth rule. First, as has already been stated, you don’t know that the economy will grow by 2 to 3 percent. It could grow by only 1 percent or by 4 percent. Second, Friedman’s reasoning assumes that the velocity of money, which is inversely related to the holding of real cash balances, is constant. That assumption has been badly wrong in the last 20 years—velocity has bounced around a lot. If, to take a concrete example, the money supply grew by 3 percent but velocity fell by 4 percent, then nominal GDP, which is Pq in the equation of exchange, would fall by 1 percent. If that happened, but the economy’s real growth rate were 3 percent, then we would have 2 percent deflation. This is not necessarily bad. There would be a problem if the decline in velocity were unanticipated and prices didn’t fall to keep the economy in equilibrium, in which case real output would fall and a recession would occur. The instability of the velocity of money is the main reason that few economists are willing to

advocate a constant-money-growth rule anymore.

Prices Are Indicators

So it doesn’t make much sense to focus on past unemployment, past economic growth, or past inflation, but simply ignoring the data and implementing Friedman’s constant-money-growth rule doesn’t seem like a good idea either. So what should a Fed chairman do? Because he cares about the future, he should pay the most attention to data that are indicators of future inflation. And the best data are those generated by the market, reflecting, as they do, the combined information and wisdom of millions of market participants. Even on the question of whether stock prices are too high, an issue on which he has at times doubted the collective wisdom of the market, Greenspan has expressed appropriate humility about market prices. In 1999 he testified before the Joint Economic Committee: “To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. Betting against markets is usually precarious at best.”

Similarly, the price of gold has often been a good indicator of future inflation: a large increase in the price of gold often indicates that the market has come to expect inflation in the future, and a large decrease often precedes a decline in inflation. Even more tight ought to be the relation between expected inflation and the spread between the yields on ordinary Treasury bonds and inflation-indexed Treasury bonds of the same maturity. Both the price of gold and this yield spread are the result of the judgments of market participants about the future, not the past. For that reason, they are far more valuable than knowledge of last month’s unemployment rate.

The idea that higher growth causes higher inflation has had one main pernicious effect on government policy. One of the latest arguments for not deregulating and not cutting government spending or taxes is that, even if such policies do increase growth, Greenspan, fearing that growth causes inflation, will raise interest rates (by reducing the growth of the money supply) and choke off increased growth. So why bother, goes the argument, undertaking policies that will increase the econo-

my’s potential growth rate? This is patently absurd. Greenspan does seem to worry that high economic growth indicates that the money supply has grown too much. But he also pays attention to taxes, spending, and regulatory policy and understands clearly the effect they can have, for good or ill, on the economy’s growth potential. If cuts in taxes, spending, and regulations raised the economy’s growth potential, Greenspan would recognize that fact and would probably not try to use monetary policy to rein in growth.

One last point: this whole discussion has taken as given that the government, through the Federal Reserve system, controls the money supply. But as Nobel-prize-winning economist Friedrich Hayek pointed out over 20 years ago, there is a case for denationalizing money, that is, getting the government out of the business of providing money and allowing competing money supplies. University of Georgia economists George Selgin and Lawrence White, and other economists, have made persuasive cases for getting the government out of the money business. But that is another story.

The bottom line is that an increase in economic growth must, all else being equal, cause a decline in inflation. ■

Cato Calendar

12th Annual Benefactor Summit

Key Largo, Florida

Ocean Reef Club

February 16–20, 2000

Speakers include Robert Novak and Edward H. Crane.

Solving the Global Pensions Crisis II: The Privatization Revolution

Cosponsored with The Economist

New York • Roosevelt Hotel

March 9–10, 2000

Speakers include José Piñera, Felipe Ortiz, William Shipman, and Milton Ezrati.

Cato University

San Diego • Rancho Bernardo Inn

July 28–August 4, 2000

Cato University

Montreal • Hotel Omni Mont Royal

October 19–22, 2000

“Utterly without constitutional authority”

War on Drugs Has Failed, Speakers Charge

The war on drugs has been “an absolute failure,” said Gov. Gary Johnson of New Mexico at a Cato Institute conference on national drug policies on October 5. Johnson, who drew sharp criticism from anti-drug leaders for being the first sitting governor to advocate legalizing drugs, argued that the government should regulate narcotics but not punish those who abuse them: “Make drugs a controlled substance like alcohol. Legalize it, control it, regulate it, tax it. If you legalize it, we might actually have a healthier society.”

The day-long conference, which was covered by CNN and C-SPAN, featured three panels of scholars and activists on drug policies and a debate between Daniel Polsby, professor of law at George Mason University, and Daniel Lungren, former attorney general of California.

One major issue discussed was the drug war’s impact on the Constitution. Yale law professor Steven Duke contended that the drug war is an “unwinnable war” that is depriving us all of “precious liberties.” Duke, coauthor of *America’s Longest War*, argued that “the anti-constitutional effects of the drug war have been so relentlessly obvious for so long that a cynic might wonder whether the Constitution is not the true enemy of the drug warriors.” Roger Pilon, Cato’s vice president for legal affairs, argued that “the war on drugs is being waged utterly without constitutional authority and therefore is inherently illegitimate.” Pilon also pointed out that many self-proclaimed friends of federalism have turned their backs on the Constitution when it comes to the drug war: “Those who have talked most strongly in recent years about the revival of federalism and have championed it at every turn are themselves leading the war on drugs.” David Kopel of the Independence Institute described how fighting the drug war has resulted in the militarization of law enforcement.

Three former members of law enforcement agencies described how their experience fighting the drug war had changed their views of prohibition. Joseph McNamara,

former police chief of San Jose and now a research fellow at the Hoover Institution, said he had learned that the drug war is unwinnable in a free country: “It’s a consensual transaction, and the people obviously treasure their privacy. There is no way the police can penetrate this world unless every-

back as a nation at this period with horror that we would deprive people of their liberty for so small an offense, a nonviolent offense, and yet we would take away so many years of their lives.” Ted Galen Carpenter, vice president for defense and foreign policy studies at Cato, argued that “the current drug war has already caused social disruptions, both in the United States and several drug-producing countries in Latin America, and has badly eroded important liberties guaranteed by the U.S. Constitution. An escalation could cause social and political havoc in portions of the Western Hemisphere and pose a moral threat to the remaining civil liberties of Americans—even in cases far removed from the drug issue.”

The conference, broadcast live on the World Wide Web, is available for viewing online along with other Cato programs at www.cato.org/realaudio/audiopages.html. Excerpts from the remarks made by Johnson and P. J. O’Rourke, Mencken Research Fellow at Cato, are available on the October edition of CatoAudio. ■



Julie Stewart deplores long prison sentences for nonviolent offenders.



P. J. O'Rourke asks tough questions about drug legalization at Cato's conference, "Beyond Prohibition."

one becomes a suspect, everyone gets stopped, everyone gets searched.”

The panelists agreed that there have been real casualties in the drug war. Julie Stewart, president of Families Against Mandatory Minimums, said that we are going through “a shameful period in American history. I look forward to the day that we can look

◆ **Randy E. Barnett**, the Arthur B. Fletcher Professor of Law at Boston University, has been named a visiting fellow in constitutional studies at the Cato Institute. Barnett is currently working on a book on constitutional interpretation, *The Presumption of Liberty*, with Cato’s support. He also participates in Cato Forums and seminars, including most recently the Cato University Summer Seminar and the conference “Beyond Prohibition: An Adult Approach to Drug Policies in the 21st Century.” Barnett is the author of *The Structure of Liberty* (Oxford, 1997) and the editor of *The Rights Retained by the People: The History and Meaning of the Ninth Amend-*



Randy E. Barnett

ment (Cato/George Mason, 1989).

◆ **Mark A. Groombridge**, a research fellow in the Center for Trade Policy Studies at the Cato Institute, is the coauthor of a new book, *Tiger by the Tail: China and the World Trade Organization* (AEI Press, 1999). Groombridge and Claude Barfield offer major recommendations about the terms of accession for Chinese membership in the WTO. They argue that increased “transparency” of China’s legal and administrative apparatus should be more of a priority for the WTO than market access issues of tariff reduction and liberalization. ■



Mark A. Groombridge

Stop Arresting People for Bad Choices

by Gary E. Johnson

I am a “cost/benefit” analysis person. What’s the cost and what’s the benefit? A couple of things scream out as failing to meet cost/benefit criteria. One is education. Regrettably, all I have done since I have taken office when it comes to education is put more and more money into a system that by all measurement is just doing a little bit worse from year to year. So I am now pressing for school vouchers. Bring competition to public school systems, and it will make a positive difference.

The other cost/benefit disaster is the war on drugs. We are currently spending \$50 billion a year on the war on drugs. For that amount of money, it is an absolute failure. The “outrageous” hypothesis that I have been raising is that under a legalized scenario, we could actually hold drug use level or see it decline. That is debatable. But with respect to drug abuse, I don’t think you can argue about that. Drug abuse would clearly decline under a legalized system.

Let me make something clear. I’m not pro-drug. I’m against drugs. Don’t do drugs. Drugs are a real handicap. Don’t do alcohol. Don’t do tobacco. They are a real handicap.

There’s another issue beyond cost/benefit criteria. Should you go to jail for simply doing drugs? I say no. People ask me, “What do you tell kids?” Well, you tell them the truth. You tell them that by legalizing drugs, we can control them, regulate them, and tax them. If we legalize drugs, we might have a healthier society. And you explain to them how that might take place. But you tell them that drugs are a bad choice. Don’t do drugs. But if you do drugs, we’re not going to throw you in jail for that.

Under a legalized scenario, there is going to be a whole new set of laws. You can’t do drugs if you’re under 21 years of age. You can’t sell drugs to kids. Employers should be able to discriminate against drug users. Employers should be able to conduct drug tests. Do drugs and do crime? Enhance the

penalty for the crime in the same way we do today with guns. Do drugs and drive? There should be a law similar to the law we have now for driving under the influence of alcohol.

Does anybody want to press a button that would retroactively punish the 80 million Americans who have done illegal drugs over the years? I might point out that I’m one of those individuals. In running for my first term in office, I offered up the fact that I had smoked marijuana. And the media were very quick to say, “Oh, so you experimented with marijuana?” “No,” I said, “I



Gov. Gary E. Johnson

smoked marijuana!” This is something that I did, along with a lot of other people. I look back on it now and I view drugs as a handicap. I stopped because it was a handicap. But did my friends and I belong in jail? I don’t think that we should continue to lock up Americans because of bad choices.

Legalization means we educate, regulate, tax, and control the estimated \$400 billion a year drug industry. We need to make drugs a controlled substance just like alcohol. Perhaps we ought to let the government regulate it; let the government grow it; let the government manufacture it, distribute it, market it; and if that doesn’t lead to decreased drug use, I don’t know what would!

A teenager today will tell you that a bottle of beer is harder to come by than a marijuana joint. The Partnership for a Drug Free America was bragging to me that it was responsible for the “Here’s your brain, and here’s your brain on drugs” ad. Well, some kids believe that, perhaps three-year-olds, maybe even nine- or ten-year-olds. But at some point, kids have friends who smoke marijuana for the first time. Like everybody else, I was told that if you smoke marijuana, you’re going to go crazy. You’re going to

lose your mind. Then you smoked marijuana for the first time and none of those things happened. Actually, it was kind of nice. And then you realized that they weren’t telling you the truth. I envision advertising that tells the truth, which says drugs are kind of nice and that’s the lure of drugs. But if you continue to do drugs, they are a real handicap. We need to have an honest educational campaign about drugs.

Drug Czar Barry McCaffrey has made me his poster child for drug legalization. He claims that drug use has been cut in half and that we are winning the drug war. I don’t buy that for a minute, but let’s assume that it’s true. Let’s assume that drug use has, in fact, dropped in half. Well, if it has, in the late 1970s we were spending a billion dollars federally on the drug war. Today, the feds are spending \$19 billion a year on the drug war. In the late 1970s, we were arresting a few hundred thousand people. Today, we’re arresting 1.6 million people. Does that mean that as drug use declines by another half we’re going to be spending \$36 billion federally and arresting 3.2 million people annually? To follow that logic, when we’re left with a few hundred users nationwide, we’re going to be spending the entire gross national product on drug law enforcement!

I want to tell you a little bit about the response that I’ve been getting to what I’ve been saying. Politically, this is a zero. For anybody holding office, for anybody that aspires to hold office, this is verboten. But what I want to tell you is that among the public, this is absolutely overwhelming. This is the biggest head-in-the-sand issue in this country today. In New Mexico, I am being approached rapid fire with people saying “right on” with your statements regarding the war on drugs. And I want to suggest to you that the public reaction is 97 to 3 positive.

What I believe I have discovered is that the war on drugs is thousands of miles long, but it’s only about a quarter-inch deep. I appreciate the work that has already been done by all of you. I’ve now been given the stage, and I’m trying to make the most of it. I’m trying to communicate what I believe in: I believe that drugs are bad, but I believe that we need to stop arresting and locking up the entire country. ■

Gary E. Johnson is governor of New Mexico. This is an excerpt from his remarks at the Cato Institute’s October 5 conference, “Beyond Prohibition: An Adult Approach to Drug Policies in the 21st Century.”

"To Be Governed..."

◆He should know

The Greater Cleveland Regional Transit Authority is being sued for alleged discrimination by a group of current and former black employees, including the former director of the agency's Office of Equal Opportunity.

—*Plain Dealer*, Aug. 5, 1999

◆Go to school or go to jail? I'm thinking, I'm thinking

Vice President Al Gore yesterday promised that if he is elected president, he would make it illegal for children to drop out of high school. . . .

He made it clear that compulsory graduation from high school would be only the beginning of his "revolutionary" push for more education.

—*Washington Times*, Aug. 13, 1999

◆More funding for patronizing government programs!

You [American Indians] have suffered from neglect, and you know that doesn't work. You have also suffered from the tyranny of patronizing, inadequately funded government programs, and you know that doesn't work.

—President Clinton, remarks to the Pine Ridge Indian Reservation Community, July 7, 1999

◆Why not let them invest 12.4 percent of their income in stocks and bonds for retirement?

Former senator Bill Bradley (N.J.) . . . told union workers that "one of my absolute key objectives is to make sure that more

Americans, working families in America, get on this prosperity train."

—*Washington Post*, Aug. 20, 1999

◆As long as they show the Earth right-side up

Vice President Gore, known for his love of science education, refused yesterday to take a clear stand on whether public schools should be required to teach evolution and not creationism.

—*Washington Post*, Aug. 27, 1999

◆And the nominees for most irrelevant comparison are . . .

Scott Simon: The National Endowment for the Humanities has plans to create a passel of centers to document the cultural heritage of this nation, region by region. . . . NEH Chairman Bill Ferris has been on Capitol Hill this week lobbying Congress for start-up money. . . . Mr. Ferris, how much money are you asking for?

Mr. Ferris: These are challenge grants, which means that each of the institutions will have to match \$3 for every dollar we give them. So . . . that will be a \$50 million commitment that the Endowment will raise. And the nation will match it three-to-one with 150. So it's a \$200 million gift to the nation for the next century.

Simon: I think that's still below the price of a single B-2 bomber.

—*Weekend Edition*, National Public Radio, Sept. 18, 1999

◆Maybe he could lecture at the Brooklyn Museum of Art

President Clinton ended a small but

increasingly nasty controversy over plans to have him give the annual Jefferson Lecture, an honor traditionally reserved for well-known figures in the humanities, with a simple: No thanks.

William R. Ferris, the chairman of the National Endowment for the Humanities, had invited the president to give the prestigious lecture. . . .

A Clinton speech would have broken a 27-year tradition of evenings with intellectuals such as Robert Penn Warren, C. Vann Woodward, . . . [Gertrude Himmelfarb, Forrest McDonald, Bernard Bailyn] and Sidney Hook.

—*Washington Post*, Sept. 22, 1999

◆But they can't choose schools, just Internet sites

"Decisions about children and the Internet should be made not through one-size-fits-all government mandates but by the people who care most about the children and know them best—and that's their parents," said [People for the American Way] President Carole Shields. "Armed with real information, parents will be able to make choices that reflect their children's needs and their family's values."

—Press release, July 29, 1999

◆Family values in the drug war

A senior Energy Department official and his wife . . . were arrested this week on charges of growing and possessing marijuana after their 16-year-old daughter, armed with photographs of the plants, went to police.

—*Washington Post*, Sept. 4, 1999

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