
Currents

Up from the Ashes of the Uruguay Round

As I write this note (in mid-December), the Uruguay round of GATT negotiations appears to have collapsed. The ministerial meeting in Brussels (December 3-7) broke up in acrimonious disagreement, primarily over the issue of European agricultural subsidies. The trade policy professionals were expected to reconvene in Geneva in January to determine whether anything could be rescued from over four years of negotiations. But there does not seem to be any basis for agreement on the major issues. And a minimal package does not seem worthwhile; Congress is not likely to approve a proposed agreement that does not open foreign markets for U.S. exports of agricultural and high-technology products, especially if the agreement would open the U.S. market for textiles and apparel. The Uruguay round should be quietly interred, and we should begin to sort out the lessons from this first failure of a trade round since the creation of the General Agreement on Tariffs and Trade in 1947.

What Was at Stake in the Uruguay Round?

As should be expected, the level and distribution of net benefits from the Uruguay round would have depended on the extent of trade liberalization to which the contracting parties might have agreed. The best estimates of these effects were prepared by an Australian research group (Andrew Stoeckel, David Pearce, and Gary Banks, *Western Trade Blocs: Game, Set, or Match for Asia-Pacific and the World Economy*, Canberra: Centre for International Economics, 1990) and were presented at a Cato Institute conference in June 1990. Table 1 summarizes those results of this study that bear on the effects of a successful Uruguay round.

The net benefits of a major trade liberalization, for this study defined as a uniform 50 percent reduction in current trade barriers, would be huge—an average increase of real gross domestic product in the affected regions by more than 5 per-

Table 1. Effects of Trade Liberalization on World Output: Changes in Real Gross Domestic Product (billions of 1988 U.S. dollars)

Region	Major Liberalization	Minor Liberalization
North America	208	34
European Community	245	35
Asia-Pacific	287	26
Total*	740	95

* Excludes effects on other regions.

cent. The effects of a realistic outcome of the Uruguay round, however, would have been much smaller. For this study the Uruguay round was assumed to yield a 30 percent reduction in tariffs (similar to prior trade rounds), no change in the nontariff barriers on manufactured goods, and a small reduction in agricultural subsidies; this proved to be a strikingly accurate forecast of the scope of a possible agreement. A minor trade liberalization of this magnitude would have increased real gross domestic product by an average of .7 percent in the affected regions and about .5 percent in the United States. This seems disappointing, given the potential benefits of more substantial trade liberalization, but would still be valuable; very few potential actions by governments generate similar net benefits.

The failure of the Uruguay round, by itself, does not change the existing system of trade agreements, but it may lead to increasing protection by regional trading blocs in Europe and North America. Trade specialists have long subscribed to a "bicycle theory" of international trade, believing that continued forward movement to more liberal trade is necessary to offset the domestic political pressures for trade restrictions. The largest cost of the collapse of the Uruguay round may be increased future trade protection by either or both the European Community and the United States and Canada. Fortunately, the Australian study also presents valuable estimates of the effects of potential future trade policy changes in these regional blocs. Table 2

Table 2: Effects of Potential Future European Community–North American Trade Policies on World Output: Changes in Real Gross Domestic Product (billions of 1988 U.S. dollars)

European Community– North American Policy	Effect on			
	North America	European Community	Asia-Pacific	Total*
Restrict–Restrict	-64	-132	-18	-214
Restrict–No Change	-40	-52	-16	-108
Restrict–Liberalize	42	38	53	133
No Change–Restrict	-24	-80	-2	-106
No Change–No Change	0	0	0	0
No Change–Liberalize	93	94	64	251
Liberalize–Restrict	7	37	7	51
Liberalize–No Change	31	117	9	157
Liberalize–Liberalize	124	211	63	398

* Excludes effects on other regions.

presents the “trade policy payoff matrix” reported in this study.

The disturbing but unsurprising conclusion from these estimates is that all regions would lose from a trade war between North America and the European Community. The more encouraging but less obvious conclusion (other than to economists) is that all regions would benefit from trade liberalization by either bloc, *even if the other bloc increases its trade barriers*. Moreover, the net benefits from a major trade liberalization by either bloc appear to be larger than the potential benefits from the Uruguay round, even if the other bloc does not reduce its trade barriers. In other words, each bloc would benefit from reducing its own trade barriers, whatever the trade policies of the other bloc; trade policy is not an international “prisoners’ dilemma.” The political problems of a unilateral reduction in trade barriers are domestic, not international. A major trade liberalization by both blocs, of course, would generate the largest net benefits and need not be dependent on a complex multilateral negotiation.

In summary, the benefits of the Uruguay round are the difference between what might have been gained and what might now be lost. If the collapse of the Uruguay round leads to a trade war between North America and the European Community, the net benefits of even a minor trade liberalization would be around \$300 billion to the world and around \$90 billion to the United States. That is what was and still is at stake.

Why Did the Uruguay Round Collapse?

The reasons are many, and there is enough blame to go around. As explained in the article in this

issue by Philip Trezise, the issues addressed were unusually difficult: the attempts to reintegrate agriculture and textiles under the GATT rules, to extend GATT coverage to services, intellectual property, and investment, and to correct some festering abuses of existing GATT rules. Moreover, broad agreement on each major issue was dependent on broad agreement on the other issues; a reluctance to bargain on any major issue by any substantial group of governments would block a general agreement. In the end, the issue that broke the Uruguay round was the European agricultural subsidies, but the round could well have foundered on other shoals.

The Uruguay round was also the victim of pace and priorities. The pace of negotiations, given the range of complex issues, was unusually sedate. Interim reports in December 1988 and June 1990 reflected no progress on any major issue, and by fall of 1990 the major governments had other, higher priorities: for President Bush, the budget and the Gulf confrontation; for Britain, the fall of Thatcher; for the European Community, the 1992 project and the opening of Eastern Europe. In the end the Uruguay round, like Rome, did not so much fall as just peter out. If the media coverage was accurate, few people seemed to notice and fewer cared.

The U.S. government both set the agenda for the Uruguay round and sustained the pressure for a successful agreement, but was not entirely blameless for its failure. The increasing unilateralism of U.S. trade policy, the proliferation of GATT-inconsistent quantitative restraints, and the aggressive implementation of the antidumping code had alienated many other governments. And, during the negotiations, the U.S. government opposed measures that would open our market for maritime and telecom-

munications services. The U.S. negotiators, of course, work under a special handicap; they speak for the administration but not for Congress. And congressional approval of a protectionist textile trade bill in October 1990 was a clear signal that Congress would not approve a Uruguay round agreement that opened some of our protected markets unless it included strong measures to open foreign markets to U.S. exports. The objective of trade agreements is to constrain the pressures for mercantilist policies that arise from domestic policies. The potential for a trade agreement, however, is always constrained by the domestic political choice between the bird in hand and the two in the bush. And the schedule for completing and approving the Uruguay round proved to be bad timing. The U.S. recession beginning in the fall of 1990 will probably continue through the months that Congress would have reviewed the Uruguay round proposals, and thus will reinforce the relative political concern about those industries that are threatened by more open markets. As you read this note, the trade negotiators may have cobbled together some minimal Uruguay round agreement. Even a minor trade liberalization deserves support, but the prospects for congressional approval are not promising.

Where Do We Go from Here?

The immediate problem of the collapse of the Uruguay round is the prospect for a proliferation of minor trade disputes between the United States, the European Community, and the Asian nations. Some of the disputes, such as the closed Japanese market for rice, were expected to be resolved as part of the multilateral negotiations and will be renewed. Other disputes will develop as the European Community resolves the remaining issues in its 1992 project. The United States has a significant stake in many of these issues, but it will be important to avoid a pattern of retaliation that could end in a general trade war among North America, Europe, and Asia.

One might hope that American politicians would recognize the substantial net benefits of unilateral U.S. trade liberalization, but this seems unlikely. Nevertheless, some unilateral measures seem possible. Most-favored-nation treatment could be extended to the Soviet Union and Romania in response to improvements in their political and human rights conditions. Some of our most egregious trade restraints, such as on sugar, could be relaxed as part of a more general pattern of opening



"Send it back to committee—oh—this is committee."

trade to the developing countries. Such small measures have small benefits, but they help offset the conditions that led to an accumulation of mercantilist measures. The U.S. government should also consider a measure that would both increase U.S. agricultural exports and substantially raise the cost of the European Community's common agricultural policy. U.S. price supports set the world price on a number of major crops. A credible threat to reduce these price supports may be the only effective means to discipline Europe's export subsidies and to provide U.S. leverage on the remaining issues in the 1992 project.

The United States has already embarked on an opening to the south, starting with trade negotiations with Mexico. (See the article by Peter Morici in this issue.) The gradual development of a dollar bloc in the Americas would be valuable to the participating countries and need not be threatening to other regions. Care should be exercised, however, to assure that these bilateral or regional trade agreements are GATT-consistent to avoid an increase in trade barriers at the combined borders of the participating nations. The U.S. government should also make it clear that these regional agreements are regarded as a complement to, not a substitute for, GATT. Despite the complications and frustrations of multilateral negotiations, the GATT framework is worth preserving, and a multilateral trade agreement is always preferable to a bilateral agreement of a similar scope.

Finally, the U.S. government should quietly initiate work to prepare for a next GATT round to begin no sooner than 1993—after the next U.S. election, after the completion of U.S.-Mexico agreement, after completion of the Europe 1992 project. The agenda for the next round should probably be less ambitious. GATT may not be the best framework to resolve issues affecting intellectual property, the regulation of service industries, etc. Some new approach to achieve a reduction in both tariff and quantitative trade restraints should be considered, possibly to replace all quantitative limits with tariffs and then to use the traditional GATT approach of a gradual uniform percentage reduction in the remaining tariffs. In the meantime, the potential for the next GATT round would be well served by U.S. trade policy that demonstrates a commitment to free trade, both in rhetoric and in practice.

W.N.

What Do We Know about Energy Security?

The sharp increase in petroleum prices following the Iraqi invasion of Kuwait rekindled interest in the subject of energy security. The crisis, however, also resurrected many of the same myths and misunderstandings that have surrounded energy security since the early 1970s. Thus, it is useful to enumerate some of the things we do and do not know about energy security. Recognition of both may help us avoid the misunderstandings and policy mistakes of the past and may give new impetus to filling important knowledge gaps.

Lessons That Should Have Been Learned

Lesson 1. Oil prices are influenced by market forces reflecting changes in both demand and supply. Oil price movements such as those observed after the Iraqi invasion of Kuwait are neither inexplicable nor inherently irresponsible.

Public misunderstanding of this issue reflects a fundamental misperception of how markets work and a preoccupation with equity that is difficult to reconcile with the workings of a market economy. Petroleum prices depend not just on production costs, which influence supply behavior, but also on

the willingness to pay of petroleum demanders. A shortage in the market causes the price to rise so that less valuable uses of petroleum are curtailed and substitutes are sought where possible.

Just as important, the *anticipation of future scarcity* will cause an increase in *current* petroleum prices; impending scarcity registers in the market right away. If oil prices are expected to rise in the future, inventory holders will bid up the prices as they seek to acquire additional stocks to hedge against higher petroleum costs, or to profit from the anticipated price increases. This helps explain why prices increased so quickly after the Iraqi invasion. The “arbitraging” serves a useful social function by spreading the burden of expected scarcity over time. The same lesson is conveyed by the precipitous drop in oil prices after the air attack began against Iraq, when market participants seemed to conclude that prosecution of the war would not greatly disrupt oil markets.

In an integrated world petroleum market these adjustments will occur for both crude oil and product prices without regard for national boundaries, import dependence, diversity of supply sources, size of existing petroleum stocks, or their historical cost. Even if a country has enough indigenous oil supplies or inventories to negate completely any shortfall of normal deliveries, current or expected scarcity elsewhere would cause petroleum prices in that country to rise immediately.

This phenomenon is frequently observed in grocery markets, where a crop freeze or a fad-induced surge in demand can raise prices overnight. And certainly no one expects all prices in residential housing markets automatically to equal historical acquisition costs. Why should petroleum be any different?

Lesson 2. Markets are quite effective at allocating scarce petroleum resources, even in a crisis; direct intervention in that process is risky and unwise, except perhaps in the gravest of national emergencies.

This point is amply illustrated by U.S. experience with oil price controls, nonprice rationing, and gasoline lines in the 1970s and should require little additional explanation. Government authorities simply do not have the information necessary to replace market allocations without imposing enormous economic costs.

Lesson 3. While international petroleum markets are certainly not textbook examples of perfect competition, viewing those markets as governed

exclusively by a powerful OPEC cartel or by international petroleum companies that engineer scarcity at will is fundamentally inaccurate.

Despite popular belief, the oil price shocks of the 1970s had little to do directly with drops in oil supplies; they resulted primarily from turmoil in the market that caused rapid jumps in demand. While OPEC seems to have some control over the market (prices fell more slowly in the early 1980s than one might have expected in a perfectly competitive market), they do not control the market (witness their inability to sustain higher prices after the 1973 disruption or to reverse the 1986 price collapse).

The ability of international oil companies to control the market is even more limited: diversification of crude supplies, nationalizations, and entry of new companies (state-owned and private) have eliminated the control of the market by a few large firms that prevailed earlier in this century. The explosion of spot trading in petroleum markets further limits the market power of OPEC and the major oil companies by providing a ready source of alternative supplies or distribution channels with anonymous buyers and sellers.

Lesson 4. Dependence on oil imports and vulnerability to energy disturbances are fundamentally different issues.

Any costs of import dependence derive from increased wealth outflows to pay for foreign oil purchases, whether or not the market is disrupted. In contrast, the costs of petroleum market disturbances depend primarily on the importance of energy in economic activity and the sensitivity of economic activity to relative changes in energy costs, not on imports. The differences in the two types of costs are illustrated by the sharp recession Britain experienced after the 1979 oil price shock, although it was rapidly approaching oil self-sufficiency, while Japan experienced virtually no downturn in 1979 and has continued robust growth although it is totally dependent on petroleum imports.

Lesson 5. Energy security problems associated with disturbances in the petroleum market are fundamentally issues of energy price changes, and how these changes affect the economy, not issues of physical supply availability.

While people still refer to the disturbances of the 1970s as embargoes, such events are impossible in the absence of a direct naval interdiction: the market shares any imbalance between demand and supply

among all nations. Nor are petroleum market disturbances driven just by supply changes, as already noted. Above all, the economic consequences of oil shocks depend on petroleum *prices*, not just physical availability. Significant shortages *never* will be seen in a well-functioning market, but price increases signaling increased resource scarcity can be. These price changes should be the focus of policy.

Lesson 6. Energy security is fundamentally an international problem that transcends any one country's supply picture or policy measures; effective measures to countervail energy disturbances may require significant international cooperation.

To illustrate this point, the SPR's maximum current release rate of roughly 3 million barrels per day could easily be swamped by a worldwide surge of panic buying. Only a concerted effort to release stocks or curb demand surges by other countries, notably the industrialized nations belonging to the International Energy Agency (IEA), could make a significant impact, given the relatively small share of any country in the entire world oil market.

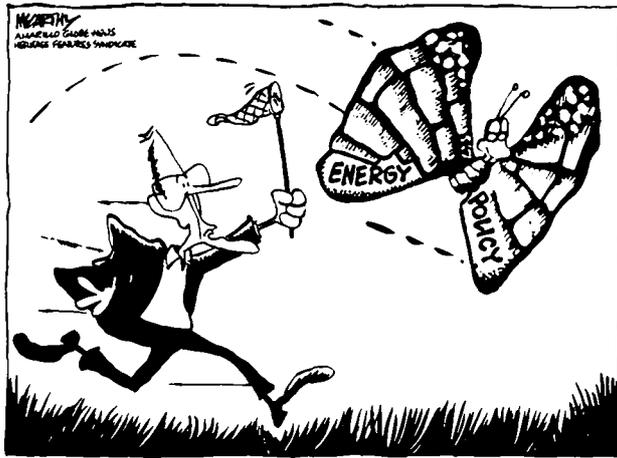
Gaps in Our Knowledge

Lesson 7. Our capacity to project accurately longer-term changes in petroleum supply and demand, especially OPEC behavior and technical change, is woefully limited. The same is true of our ability to understand or predict short-term responses during a crisis, particularly panic-driven inventory changes, and our ability to gauge in advance the probabilities of oil market disturbances of various magnitudes and durations.

None of these points requires much further elaboration after one considers the track record of the past, such as the surprise that greeted the marked decline in the ratio of energy use to GNP after the price increases of the 1970s or the abrupt decline of petroleum prices in 1986.

Lesson 8. The costs of both long-term oil import dependence and short-term energy price disturbances continue to be disputed.

For example, an increase in petroleum imports by a large buyer such as the United States may have a disproportionate effect on the total cost of petroleum imports by bidding up world petroleum prices. There is, however, considerable disagreement in practice about the magnitude of this cost. Still more uncertainty surrounds other possible indirect costs associated with expanded petroleum imports



through effects on inflation, the trade balance, and vulnerability to future shocks.

Regarding short-term energy price disturbances, it has long been an article of faith among energy security analysts that such shocks cause considerable economic losses through unemployment, lowered productivity, and reduced capital formation. Some macroeconomists, however, have disputed this view. In a 1989 Resources for the Future study (*Energy Price Shocks and Macroeconomic Performance*), my colleague Douglas Bohi carefully weighs the evidence connecting energy prices and macroeconomic performance for several industrial countries. He concludes that the evidence does not support a strong connection and that misdirected macroeconomic stabilization policies may be the primary culprit behind the poor economic performance many countries suffered after the disturbances of the 1970s. Bohi's study does not constitute the final word on the subject. It seems, however, that we can no longer uncritically postulate large macroeconomic losses from energy price disturbances.

Lesson 9. As a consequence of the uncertainties about petroleum market behavior and social costs, there is no analytical consensus to support the resolution of such key policy issues as the size of the SPR, the timing and pace of its use, the structure of energy taxation, and long-term support of R&D.

Recommending a bundle of security policies for petroleum markets was once considered to be fairly easy. The standard view was that petroleum imports are undesirable, so a significant tariff is warranted (although not in a crisis) to reduce imports, to lower world oil prices, and to lessen the economy's ex-

posure to future crises. The only concern about SPR size was that the target size of 750 million barrels was too low, given the usefulness of stocks for ameliorating disruption costs. In addition, it was thought that stocks generally should be used early and aggressively in a crisis to forestall panic buying, a spiraling macroeconomic problem, and a ratcheting of oil prices to a new plateau. Finally, it was thought that long-term R&D policy should focus on concerted efforts to develop conservation methods and substitute supply options, even if they are not cost-effective today, because they probably will be in the future.

The uncertainties about petroleum market behavior, disruption risks, and disruption costs noted above cast at least some doubt on every one of these propositions. Imports may not be so deleterious as we had thought, and the ability of buyers to influence oil prices may be fairly limited. The uncertainty about the importance of macroeconomic costs from energy price disturbances weakens the case for filling the SPR to 750 million or more barrels. The liquidity of the oil market with the growth of spot trading weakens the case for rapid SPR release in a crisis. And the 1986 price collapse provided a vivid illustration that oil prices are not on an inexorable upward climb, thereby complicating the job of picking winners in R&D policy.

Lesson 10. Despite the existence of the IEA, there continues to be uncertainty about the potential responses of other industrialized nations to changing oil market conditions and the prospects for international cooperation; the picture regarding developing countries is even more murky.

The IEA may provide a valuable forum for communication and long-term cooperation. The treaty establishing the IEA in 1974, however, contains as its centerpiece for short-term crisis management an extremely misguided program for bureaucratically reallocating oil supplies. Fortunately, this program is fairly widely perceived as counterproductive and probably will not be exercised. There are, however, only limited measures for effective cooperation in its place. There are understandings among the United States, Japan, and Germany for coordinating the use of strategic oil stocks in a crisis, but the strength or scope of these understandings is unclear. The official IEA position continues to be that countries may pledge to pursue a variety of different responses to a disturbance, including restraints on oil demand as well as stocks. Yet, little has been done—at least publicly—to create a sense

of mutual assurance that concerted and productive policy actions will be undertaken. And even if such assurances exist among governments, their practical effects will be muted if the private sector does not believe them.

While the current share of total world energy used by developing countries is fairly small, this share is likely to grow significantly in the future. Thus, cooperation on long-term energy policies that includes the developing countries may be of substantial value. Such cooperation currently appears elusive, however, particularly in light of disagreement over what common interests need to be addressed.

Policy Options

The large uncertainties alluded to above lead to a preference for economic policies that can provide benefits under a wide variety of circumstances while avoiding significant harm. In response to the Iraqi invasion of Kuwait, this reasoning emphasizes the importance of allowing market adjustments without bureaucratic intervention and not overreacting so long as the economic dimensions of the disturbance remain limited.

This past fall oil prices had risen considerably from their precrisis levels, and the U.S. economy was weakening. Other oil producers, however, have more than offset the supply drop that occurred after the invasion. Moreover, the macroeconomic indicators are disconcerting but not yet disastrous.

Under these circumstances the best policy response may be some accommodation in microeconomic policies while otherwise awaiting developments. The SPR has been used to a limited extent to dampen oil prices since the counterattack against Iraq, with some international cooperation through the IEA. But the importance of these responses has been lessened by a softening of the oil market and growth of private petroleum inventories. A high SPR drawdown rate would have been imprudent given the lingering risk of considerable worsening in the Persian Gulf situation.

A different set of policies might then be called for in the future. But this point only underscores perhaps the most important lesson for energy policy imparted by the Iraq crisis: the need to cope with pervasive uncertainty in world petroleum markets. In the face of this uncertainty, difficulties in designing policies are only compounded by continuing lack of knowledge about how petroleum markets operate and about the potential benefits or costs of

different measures. Despite the large volume of research on energy security since the early 1970s, much remains to be done.

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Price-Cap Reform of Telecommunications Regulation: “A Penny Saved . . .”

On July 1, 1989, changes in certain Federal Communications Commission “rules concerning rates for dominant carriers” in telecommunications went into effect. That bland bureaucratic language obscured the significance of the reform. Previously approved by the FCC, those changes at least partially swept away the myriad complex rules that had governed AT&T’s prices and profits for decades, substituting in their place so-called “price caps.” Price caps for the major local exchange carriers—primarily the Bell operating companies—commenced on January 1, 1990.

The FCC actions have been remarkable both in their scope and speed. In all, more than \$60 billion of telecommunications services have undergone substantial reform of their traditional regulatory mechanism. Price caps represent an alternative never tried on this scale. Moreover, from initial discussion to implementation, price caps for AT&T took less than two years—despite much controversy and a very sizeable docket of comments, notices, and orders. For major regulatory action in this country, the swiftness of that schedule is notable.

The Need for Reform

The problems with rate-of-return regulation are well known. Perhaps most fundamentally, by setting prices that guarantee that all costs are covered, the regulated company has no obvious incentive to conserve on costs. Any cost savings or added revenues from product innovation will be recaptured by the regulator (although normal delays in regulatory response might incidentally improve matters a bit).

In addition, individual service prices under rate-of-return regulation are generally set on the basis of “fully distributed costs,” which allocate common costs in some arbitrary way. This results in uneco-

conomic prices and distortions in consumer usage. And the regulatory process itself has long been subject to criticism, for both its costliness and inefficacy.

The dynamic technological, product, and competitive environment of the long-distance market of the 1980s exacerbated these problems with traditional regulation. As a result, most observers agreed that rate-of-return regulation of AT&T was an idea whose time had passed.

Since profit recapture creates the disincentive for cost savings, one solution to this regulatory problem would be to sever the link between the price the company is allowed to set for its product and the costs it reports. If its price no longer responds immediately and fully to changes in its costs, the company will squarely confront the consequences of its own actions. Unnecessarily high costs will cause its profit residual to fall, rather than cause price to rise. But if the company achieves additional cost savings, those flow directly to the bottom line: a penny saved is a penny earned.

In this scenario, since price is no higher, consumers are just as well off as before. More generally, however, the cost savings may be shared with consumers. Price caps therefore do not represent a "zero-sum" game, in which one party's gains necessarily imply losses for the other. Rather, price caps are one of those infrequent "positive-sum" policy reforms. A well-designed plan can leave both consumers and the company better off.

This basic principle of price caps for AT&T and the local exchange carriers is not altogether novel. It previously appeared in the form of incentive regulation—common in gas and electric utilities for over a century in Great Britain and the United States—in which the company's allowed rate of return does not *completely* revert to some norm. Rather, the company is permitted to retain some fraction of incremental profits: a penny saved is some number of mills earned. Price caps also have direct precedent in United Kingdom's regulation of British Telecom since 1984 and in state telecommunications regulation in the United States during the past decade.

Implementing Price Caps

These bare-bones principles, of course, need some flesh to become a viable price-cap plan. For one thing, over time any company's unit costs will change, and therefore simply fixing price will result in windfall gains and losses. But price cannot be adjusted for the company's own incurred costs, since

that would recreate the very problem of rate-of-return regulation. Instead, cost information outside the control of the price-capped company must be used.

For AT&T the FCC adopted a formula approach that shifts the cap in accordance with exogenous indexes of the firm's likely cost changes. The latter are measured by the net of changes in the costs of its inputs and in its productivity (that is, output per unit of input). For example, if input prices rise by 5 percent in some year, while productivity grows by 3 percent, the cost of a unit of output (and hence price) should rise by 2 percent.

For the input cost measure, the GNP price index was chosen in preference to the better-known consumer price index because of the latter's heavy weighting of food and other factors not especially relevant to AT&T's production process. The productivity offset factor was hotly contested. On the basis of several studies of AT&T's productivity experience, the FCC ultimately settled on a 2.5 percent annual offset. This was increased to 3.0 percent in the formula, to ensure that consumers secure the first .5 percent of incremental benefits under the plan.

These considerations resulted in a formula that adjusted the price cap by the change in the GNP price index minus 3.0 percent each year together with certain "exogenous factors" largely determined by the FCC.

There is a second reason why the original description of price caps is overly simplistic: AT&T and most real-world companies offer numerous services and prices. In fact, AT&T asserted that its rate-of-return tariff consisted of over 6,000 rate elements. Capping each of them would result in more stringent regulation than under rate-of-return regulation. In addition, economic theory demonstrates that price caps at the broadest possible level of aggregation (in the limit, a *single* cap on a weighted average of all prices, leaving the company complete freedom within that average to set individual prices) can reduce the distortions in individual prices.

The final plan for AT&T aggregated services into three broad categories or "baskets," roughly, message toll service (ordinary residential service), 800 service, and all other (primarily business) services. These provide AT&T with great pricing flexibility with respect to the rate elements of each service. Yet they avoid potentially large income transfers that could result from sudden price increases on less-competitive services (message toll service, for example) that might be offset by lower prices on more competitive business services.

The plan provides for certain secondary constraints on AT&T's pricing. For example, it limits the increase in any service price in a given year to five percentage points more than the overall cap for that service's basket. No such constraint limits AT&T's price decreases, although for those greater than 5 percent, the plan incorporates an antitrust standard for predation: AT&T is required to show that the resulting price covers variable costs. In any event, the constraining effect of these "bands" decreases over time.

The final difficulty that price-cap principles confront concerns the long run. No matter how carefully designed, any formula-based prices will eventually produce unintended deviations from underlying costs. At that point, the adversely affected party (either the company or consumers) will inevitably seek revision of the plan's parameters. But a revision based on the company's actual cost and profit experience once again raises the prospect of blunting incentives. The firm that knows that its performance will ultimately be held against it will most likely modify its behavior to prevent the appearance of profits.

Some have argued that any such revision effectively converts price-cap regulation back into something akin to rate-of-return regulation and thus renders this reform meaningless. For several reasons that assessment is unduly pessimistic. For one thing, blunting incentives (which indisputably occurs when parameters are reset) is not the same as destroying them. Moreover, maximum profit incentives are not necessarily the exclusive objective. Recapturing unforeseen windfall benefits for consumers is a bona fide policy objective. Both theory and evidence show that maximum benefit to consumers plus the company is generally achieved by something other than "hands-off" price caps.

Lastly, even if desirable, "hands-off" price caps are simply impractical. No corporate, regulatory, or legislative body can credibly commit to never subsequently revisiting the original terms of such an arrangement. Nor should they. As a result, practical price-cap plans must bear in mind the inevitability of a review and revision of plans' parameters.

Price Caps in the Long Run

All price-cap plans (except perhaps for one- or two-year price freezes) contemplate a "truing-up" process. The FCC's plan for AT&T proposes to conduct a general "performance review" during the fourth

year. The review will consider numerous factors, including the company's earned rate of return. In price-cap regulation of British Telecom, the first cycle was five years. Since British Telecom's profits had risen significantly, its subsequent productivity adjustment was in fact increased from 3.0 percent to 4.5 percent.

Whereas both of those plans rely on a relatively general review process, the FCC's price-cap plan for the local exchange carriers is more explicit, has a shorter cycle, and involves more sharing. These features stem from the fact that less is known in advance about local carriers' productivity, and what is known suggests that different local carriers have different productivity. Hence, no single number is correct for all of them, too little is known to be able to set reliable company-specific productivity offsets, and unacceptable windfalls are otherwise more likely to occur than for AT&T.

A local exchange carrier may therefore be subject to a price cap that is adjusted annually by the change in the GNP price index, less 3.3 percent, plus-or-minus a factor that recaptures a specified portion of the gap between its earned rate of return and a prescribed norm of 11.25 percent. For greater deviations from the norm, increasing (marginal) increments are recaptured, and past some specified point, all excesses—positive or negative—are captured and passed through.

On the continuum between rate-of-return regulation and pure price caps, the plan for local exchange carriers is clearly farther away from pure price caps than the AT&T plan. Indeed, for large earnings deviations, the plan for local carriers converges to traditional rate-of-return regulation. That, of course, does not condemn the plan, since it may nonetheless represent the maximum reform consistent, for example, with available information about company productivity. The alternative of price caps with *incorrect* parameters is not obviously preferable to a plan that involves some blunting of efficiency incentives for the sake of greater stability. That stability may itself ensure greater longevity for a plan that begins with imperfectly selected parameters.

In addition, the plan for local exchange carriers incorporates a second novel feature. At its option, a local carrier can select an alternative to the plan parameters just described in which a higher productivity offset (4.3 percent) is traded off against more modest rates of recapturing incremental profits. This option permits a highly productive company to retain more of any productivity increase, but to begin with a more challenging level. Appropriately

devised pairs of productivity levels and recapture rates can induce companies to the choices that simultaneously maximize their—and consumers'—benefits.

Prospects for Reform

Price-cap reform of telecommunications regulation can significantly benefit both consumers and the carriers. Since pure price caps are impractical in anything other than the very short run, the operational choice is among alternatives that to varying degrees strengthen incentives. It is possible, for example, to construct a plan that largely recreates rate-of-return regulation, but it is also possible to convince a company that price will remain fixed long enough to justify its cost-saving efforts.

Thus, we should not underestimate the importance of the initial design of price caps. But it also seems possible that regardless of initial design, over time most plans will drift away from the pure price-cap model and toward something like rate-of-return regulation. As in the British Telecom case, this erosion of the process results from the pressure—whether from company or consumers—to take actual performance into account in the inevitable review cycle.

Once such regulatory responses become understood, the company can be expected to adapt its own behavior, and some (perhaps many) of the benefits of price caps may disappear. As a result, the greatest benefits of price-cap plans will probably arise in the early rounds of these plans and with plans that initially follow a relatively pure price-cap model. Less impact can be expected from those plans that tend initially to follow the model of traditional rate-of-return regulation or those that have already undergone several iterations of the review process.

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Seidman's Imperialism?

In the early 1980s a handful of economists began to suggest that federal deposit insurance might be undermining the health of the banking industry by encouraging excessive risk-taking. William Isaac and Todd Conover, who were then chairman of the

Federal Deposit Insurance Corporation and Comptroller of the Currency, respectively, called for a careful rethinking of federal deposit guarantees. These critiques caught the public and much of the financial press off guard. The response repeatedly offered as the conventional wisdom was, "If it ain't broke, don't fix it!" Ten years later few observers suggest that federal deposit insurance is not "broke."

The savings and loan crisis exploded onto the national scene in the late 1980s. Federally insured depositors proved willing to provide virtually unlimited funding to S&L owners and managers, no matter how incompetent, fraudulent, or unlucky, and the industry became a financial black hole. The present value of the cleanup bill may be as high as \$200 billion, and when interest expenses are included, the total cost will easily top \$500 billion. Now the virus that infected the thrift industry seems to be threatening commercial banks.

Bank failures mounted dramatically throughout the 1980s. From 1940 to 1979, only 299 insured commercial banks failed; from 1980 to 1989, 879 banks were closed. Since 1987, the FDIC has quietly expanded its forbearance program for banks that have insufficient capital because of economic events beyond management's control. Reserves of the FDIC's Bank Insurance Fund have fallen to historic lows. Losses to the fund are expected to top \$4 billion for 1990, leaving less than \$10 billion in reserves to protect almost \$3 trillion in deposits.

In September 1990 the General Accounting Office warned Congress that any major drain on the fund (because of rising bank failures associated with a recession, for example) could lead to the bankruptcy of the Bank Insurance Fund. For observers who followed the thrift industry crisis during the 1980s, this all has a disturbing feel of *déjà vu*. Will U.S. taxpayers be asked to bail out the banking industry in the 1990s?

Despite (or perhaps because of) the failing health of the banks' federal insurer, William Seidman, outgoing chairman of the FDIC, has used his time in office to systematically expand the guarantees provided by federal taxpayers. As recently as October 1990, the FDIC made explicit its policy of protecting foreign deposits. The action was especially subject to criticism because deposit insurance premiums are levied against domestic deposits only, creating the presumption that foreign deposits are nominally uninsured. An FDIC spokesman defended the move as "necessary to protect the competitive position of the nation's largest banks."

The move to extend the U.S. safety net to foreign depositors was only the latest of several unilateral

expansions of federal deposit guarantees during Seidman's tenure. Another important policy innovation revolved around "BIC/GIC" competition. In the market for pension fund investments, BICs (bank investment contracts) compete directly with GICs (guaranteed investment contracts) offered by insurance companies. The BIC/GIC market controls about \$150 billion in assets, with about \$35 billion up for grabs each year in new business and rollovers.

Under Seidman, the FDIC determined that when a pension fund manager purchases a BIC, federal deposit insurance will be "passed through" to the individual pensioners. That is, the pension fund investment is fully protected, not just to \$100,000, but up to \$100,000 times the number of individuals participating in the pension plan. This federal guarantee gives banks an artificial advantage over insurance companies in competing for funds. From 1987 to 1989 the banks' share of the BIC/GIC market grew from zero to 30 percent. Taxpayers' potential liabilities have consequently expanded for two reasons: first because each BIC is treated as multiple deposits and second because banks have been given an advantage in attracting funds from the insurance industry.

It is true that the FDIC under Seidman has often taken care to differentiate between holding company and bank creditors, allowing the former to experience losses while protecting the latter. But the FDIC has also encouraged more liabilities to be brought under the protective umbrella of the bank by creating ever more certain guarantees for bank creditors. In a proposed rulemaking, for example, the FDIC sought to expand the definition of deposit to include "any liability of [an] insured bank on any promissory note, bond, acknowledgment of advance or similar obligation that is issued or undertaken by [an] insured bank as a means of obtaining funds." Such an official definition would leave virtually nothing unprotected.

In light of extensive criticism of expansive government guarantees and a dwindling reserve fund, there has been considerable speculation about why the FDIC has been so generous with its protection over the past few years. Some observers have suggested that in extending federal insurance to foreign depositors and in attempting to redefine deposits, the FDIC may be looking to expand the base against which it can collect premiums. Others have suggested that Seidman simply lacks faith in the ability of large depositors and other creditors to discipline banks adequately. And then there is the argument that explicit, expansive deposit guarantees help U.S. banks compete more effectively. Any or all of these



could provide part of the explanation, but there is probably a more fundamental consideration.

In congressional testimony in February 1990, Seidman defended his policies by noting, "Because it normally provides the *lowest cost solution to the insurance fund*, the FDIC has handled most bank failures, and all failures of large institutions, in a way that protects virtually all depositors and other general creditors of the bank" (emphasis added). With that statement Seidman inadvertently acknowledged the problem that has plagued the administration of the federal deposit insurance system throughout its history.

The policymakers who initiated federal deposit insurance clearly understood the moral-hazard problem created by an expansive system of insurance. As a result, deposit insurance was limited, initially to \$2,500 per account. But the pressure was always there for the FDIC to extend protection beyond that provided by the law.

In a forthcoming Cato book, *Governing Banking's Future: Markets vs. Regulation*, Walker Todd of the Federal Reserve Bank of Cleveland describes how Congress has repeatedly criticized the FDIC for failing to adhere to legislated limits. Todd notes: "Despite legislated ceilings on coverage, the FDIC has usually succeeded in arranging complete or nearly complete payoffs to all depositors, both insured and uninsured. . . . In 1950, . . . Congress sent the FDIC a clear message: stop trying to pay off everyone. . . . In return for expected adherence to those instructions, Congress agreed to increase the deposit insurance maximum. . . . The FDIC's repeated backsliding on its commitment to retain market discipline in the resolution of bank failures and recurring surges in the FDIC's losses from failure resolutions forced Congress periodically to repeat its message of 1950. The deal was always the same: Congress reminded the FDIC that it was supposed

to consider the cost of a complete rescue of depositors before committing itself to such a rescue, and in return, Congress raised the deposit insurance limit."

Unfortunately, administrators of the FDIC, who are charged with minimizing the cost of failure resolutions, are asked to consider only the explicit outlays involved in a payout versus a merger. The more important long-term impact of 100 percent protection on banks' risk-taking and capital adequacy are simply not in the equation.

In addition, every decision by the FDIC, especially those concerning large bank failures, is second-guessed. And political appointees are generally more comfortable defending policies marked by excessive caution and protection than they are defending policies that impose unexpected losses (and, of course, losses will always be labeled unexpected). Political decisionmakers' short-time horizons lead them to overemphasize the *potential* for immediate financial disruptions and to discount long-term costs. Charles Goodhart has noted, "Success for a regulator, when the costs of regulation are not taken fully into account, can be measured by the absence of newsworthy failures."

As the history of the FDIC shows, this is a systemic problem. Expanding federal deposit insurance has much less to do with the individual heading the FDIC at any point in time than it has to do with the institution itself. If the mechanism exists for bailing out individual banks and their creditors, it will be used—perhaps not in every case, but it will be used. As a result, any substantive reform of the federal deposit insurance system designed to limit federal guarantees must substantially reduce the discretion of federal regulators in handling bank failures.

But is substantive reform really necessary? What harm is there in allowing the FDIC chairmen to continue protecting bank creditors as they see fit?

First, each decision to extend federal guarantees makes it more costly to roll back protection in the future. Decisions by bankers and their customers become further distorted in the direction of additional risk-taking. Government supervision alone is not enough; government regulators cannot compensate for a total lack of market oversight.

Furthermore, as the government's protection of bank creditors is extended, capital formation is negatively affected. Government guarantees increase the problems faced by uninsured financial institutions attempting to compete with insured banks for funds. And money flowing to insured depository institutions does more than simply change where the money is. Because of the moral hazard—the

excessive risk-taking—generated by federal deposit insurance, the overall nature of investment decisions is changed to the extent that federally insured institutions control the nation's financial capital. Financial markets work efficiently in moving capital to the regions and sectors of the economy where it is most needed when investors stand to gain from wise decisions and lose from foolish ones. Banks also act efficiently when their creditors face a loss from repeated unwise investments, but that is much less true today than in the past. Perhaps the most significant cost of the savings and loan debacle will never be fully recognized. The country lost immeasurable potential in terms of the sound business investments that were not funded because money was flowing from federally insured savers through S&Ls to empty office buildings and shopping centers in the middle of nowhere.

Finally, should the average U.S. taxpayer be asked to protect investments by pension fund managers or foreign depositors sophisticated enough to be active in international money markets? If it is only by leaning on factory workers, school teachers, and clerks that U.S. banks can compete successfully overseas, then perhaps they ought to concentrate on the U.S. market.

William Seidman's tenure at the FDIC has been a source of frustration for scholars and analysts who advocate limiting the extent of federal deposit insurance. But in criticizing the decisions since 1985 to make more explicit the agency's intention to protect foreign investors and domestic deposits above \$100,000, it is important to keep in mind that Seidman is keeping with traditions established over a half century. FDIC officials since 1933 have looked for ways to expand coverage beyond their legal mandate. Changing who heads the FDIC is not enough. The institution itself must be strictly constrained or eliminated.

C.E.

Deposit Insurance: How Much Can We Afford?

In recent months across an ever-widening spectrum of our society, the calls for deposit insurance reform have begun to grow louder. As president of a Tennessee bank holding company, let me add my voice.

Deposit insurance was created by Congress in

the 1930s to deter any future runs on banks such as the ones that occurred during the Great Depression. Originally, deposits were insured up to \$2,500. As recently as 1980, coverage was \$40,000. Today, deposit insurance stands at \$100,000, but with creative accounting and the government's tacit "too big to fail" policy, virtually all deposits are insured by the government—or rather, they are guaranteed by the taxpayer.

Deposit insurance has become an opiate that has dulled the American consumer's otherwise market-driven quest for quality bank products and services. Deposit insurance has made sound financial institutions indistinguishable from insolvent ones in the public's mind. Well-managed banks pay the same insurance rates as the most recklessly run banks. Both banker and depositor have become addicted to the false sense of security deposit insurance provides. The problem is analogous to drug use in that our society as a whole must eventually bear the economic burden of deposit insurance abuse.

Slowly, comprehension of the staggering cost of the thrift bailout is beginning to dawn on the American public. It is almost impossible to put \$250 billion in perspective. If paid today, it would cost every man, woman, and child in the United States more than \$1,000 each. But we chose instead to defer the cost to a later day. The government now proposes to finance this deposit insurance bailout with 30-year bonds. Interest expenses are projected to run the final cost closer to \$500 billion. How, in good conscience, can we leave this shameful legacy to future generations of yet unborn taxpayers?

From such an expensive and painful experience as the S&L debacle, surely there must be some significant lessons to be learned. What led to the demise of an entire industry? Could it happen to our banking system? The causes most often cited are fraud, disintermediation, speculative lending practices, and inept regulatory supervision. In reality, however, these were merely viruses that found a receptive breeding ground in an industry already susceptible to infection as a result of unrestrained deposit insurance abuse. There were no incentives for either depositors or the owners of low-net-worth S&Ls to exercise caution or restraint. The incentives actually ran the other way. Millions of brokered deposits sought out the highest rates without regard for any safety and soundness considerations. The natural immunities of our free-market system had been destroyed. Bank owners were not playing with their own money.

Nor is our commercial banking system immune to these problems. The most important difference



is that while thrifts had about \$900 billion in deposits, commercial banks have about \$2.5 trillion. If the nation's banks are ever stricken to an extent similar to thrifts, the consequences could be truly catastrophic. Our entire payment system would be at risk.

Incredibly, there is a vocal segment within the banking industry calling for even higher deposit insurance coverage—possibly unlimited protection. These bankers contend that the solution is not free-market discipline, where deposits flow to the safest and most efficiently run institutions, but ever-increasing government control, regulation, and guarantees. They contend that all banks should be reduced to the same common denominator. Deposits in Bank A would be as safe as those in Bank B, distinguished only by the rate of interest that one might pay as opposed to another. Interest rates are normally a function of risk—but not in this scenario. There would be no risk to anyone except the taxpayers. And conceivably, the sad history of the thrift industry might be repeated by an unwitting banking industry.

The time for deposit insurance reform is now. There is growing public sentiment as well as ever-increasing conviction within the banking community that the systemic disease that grows from excessive deposit insurance should not be allowed to threaten the viability of our nation's commercial banks. As with any addiction, withdrawal will be painful, and the inclination will be to postpone it. The remedies required will certainly have some unpleasant side effects. Taxpayers must be convinced that a reduction in deposit insurance is in their best interests. Bankers must accept the inevitable fact that some banks will fail. The strongest and best managed banks, not necessarily the largest, will flourish. Those that have existed on the artificial

life support of government guarantees will either adapt to a new environment or wither. At a minimum, the prescribed regimen should include the following steps.

- Reduce deposit insurance coverage from \$100,000 to \$50,000, or as an alternative, adopt a coinsurance feature beyond a minimum threshold. Give the public some incentive to put its money in well-managed institutions. Draw a distinction between insuring the savings of depositors and guaranteeing the capital of rate-sensitive investors.
- Abolish, once and for all, the tacit policy of “too big to fail.” Put money center banks on the same playing field as smaller banks. The cost of a “too large” bank failure could not be any greater than the risks we now face.
- Make insurance premiums paid by banks a function of risk. Reward well-run institutions. Penalize the reckless. Consider privatizing the insurance, with the FDIC as insurer of last resort.
- Give depositors a yardstick to measure their banks. Require regulators to publish annually a uniform rating of each bank.

Deposit insurance reform will require real political courage. It should not become a Republican or Democratic issue. Responsibility for the demise of the thrift industry rests on both sides of the aisle. Saving our banking industry from a similar fate will require a truly bipartisan effort. The standard of living we have all come to enjoy in this country depends on it.

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National Commerce Bancorporation

The Collapse of Drexel Burnham Lambert: Lessons for the Bank Regulators

The collapse of Drexel Burnham Lambert Group Inc. (Drexel) was one of the more notable financial events in recent years. Drexel was a financial services holding company with many subsidiaries involved in financial, commodities, and securities markets throughout the world. In many respects, it resembled a large bank holding company. At the end of 1989, the holding company and its subsidiaries held

approximately \$28 billion in assets—primarily loans, securities, and mortgage instruments. Ranked by asset size, this would put Drexel among the 25 largest bank holding companies in the United States. Also like a big bank holding company, Drexel engaged in foreign exchange trading and other market-making activities, and it had significant off-balance-sheet commitments. The main difference between Drexel and a banking organization was that Drexel depended on commercial paper rather than on deposits for its funding. Ultimately, a “run” by holders of its commercial paper brought about Drexel’s downfall.

Because of the similarities between Drexel and a large bank holding company, Drexel’s collapse—the problems it posed and the way they were handled by the regulators—offers some relevant evidence for two very controversial issues in bank regulation.

One issue is whether some financial institutions are simply “too big to fail” because of the effect their failure would have on broader financial markets. For years, Federal Reserve officials have warned that the sudden collapse of a major financial institution could have extremely adverse consequences for the stability of the financial system. The Fed’s concerns go beyond the risk of losses to depositors. They also include concerns about adverse spillover effects, most important on the confidence in the broader financial marketplace, on the smooth functioning of the large dollar electronic payment systems, and on the clearing and settlement systems for securities, foreign exchange, and other financial contracts.

The second issue is whether regulation and consolidated supervision of bank holding companies are necessary to protect the safety and soundness of their bank subsidiaries. Bank holding companies are closely supervised by the Fed. Their activities are limited to those “closely related to banking,” and they are subject to consolidated capital requirements. The Fed argues that it is necessary to regulate and supervise bank holding companies to protect the safety and soundness of their subsidiary banks. One of the Fed’s principal concerns is that the financial problems of the holding company or its affiliates could adversely affect the bank subsidiaries and ultimately the federal financial safety-net.

Drexel had two federally regulated subsidiaries, Drexel Burnham Lambert Inc. (DBL), a broker-dealer regulated by the SEC, and Drexel Burnham Lambert Government Securities Inc. (GSI), a government securities dealer regulated by the Federal Reserve. But the parent company, Drexel, was

neither regulated nor supervised by any federal authority. DBL and GSI, together with two unregulated subsidiaries—DBL Trading Corp., which engaged primarily in foreign exchange and commodities trading, and DBL International Bank, NV, a Curacao corporation through which Drexel conducted many of its foreign operations—generated most of Drexel's revenues and profits.

The story of Drexel's demise offers some important lessons for bank regulation and supervision.

The fortunes of Drexel's integrated financial services empire were closely tied to the junk bond market it had created. Even after its March 1989 settlement with the U.S. government for insider trading charges, DBL was among the most highly capitalized broker-dealers in the United States. But the deterioration in the junk bond market in 1989 began to have an adverse effect on DBL and Drexel. That year, 47 issuers of junk bonds defaulted or were involved in distressed exchange offers on \$7.3 billion in junk bond securities. The most notable among them was the Campeau Corporation. As secondary trading in junk bond securities began to fall and the flow of new issues slowed, Drexel's revenues declined substantially, and its inventory of junk bonds became increasingly illiquid.

Although Drexel's regulated affiliates, DBL and GSI, were healthy and continued to finance their activities primarily through secured bank loans and repurchase agreements, Drexel and its unregulated affiliates became increasingly dependent on short-term unsecured borrowings, mainly through the commercial paper market. Such borrowing is not uncommon for large broker-dealer holding companies, but most such companies hold liquid, pledgeable assets as a back-up source of liquidity. In Drexel's case, the holding company held only its illiquid investments in its unregulated subsidiaries and the excess uncollateralized securities inventory in DBL—largely junk bond securities that were becoming steadily less attractive as 1989 came to a close.

Concerns about Drexel's condition led Standard & Poor's to reduce its rating for Drexel's commercial paper in December. As a result, money market funds could no longer purchase Drexel's paper, and Drexel became dependent on a very small group of institutional lenders. These lenders continued to pull back in the early days of 1990. Those holding Drexel's commercial paper and commodity leases were not rolling over their positions and were demanding immediate payment. In effect, there was a "run" on Drexel's commercial paper. Drexel turned to its only

remaining source of funds; it began to draw capital from DBL and GSI in excess of what regulations allowed.

Officials from the SEC, the New York Fed, and the New York Stock Exchange formed an ad hoc oversight group to monitor Drexel. This group became very concerned about the threat posed to Drexel's two regulated subsidiaries by the upstreaming of funds. On February 9, 1990, the oversight group met with officials from DBL, GSI, and Drexel to discuss plans to reduce Drexel's financial exposure and restore creditor confidence. Drexel officials outlined a plan that involved reducing fixed expenses, exiting the commodities and mortgage-backed securities businesses, and liquidating DBL's positions in corporate equity and debt securities, including substantial parts of its junk bond inventory. Drexel spokesmen told the oversight group that they would meet with their lending banks to try to arrange roughly \$400 million in back-up secured financing. In addition, Drexel officials planned to speak with certain investment banks about their acquiring a 20 percent equity interest in the firm for a nominal price together with an extension of short-term bridge financing.

Successful implementation of the plan hinged on DBL and GSI's ability to continue trading with other dealers and thereby to continue to obtain short-term financing for their trading and matched-book positions. But the markets were nervous, and on February 12 many primary dealers informed brokers in the government securities market that they were no longer willing to trade with GSI. DBL and GSI were thus unable to continue financing their inventories through repurchase transactions. Later that same day, Standard & Poor's downgraded Drexel commercial paper to speculative grade, effectively ending Drexel's access to the commercial paper market. Drexel's other lenders were unwilling to continue unsecured lending, and it quickly became clear that Drexel would not obtain a bridge loan as an equity investment.

The parent company faced nearly \$400 million in loans due or being called in the ensuing days. Meanwhile, the remaining excess net capital in DBL totaled less than \$300 million. The oversight group informed Drexel that bankruptcy was the only choice. It thus prevented DBL from upstreaming excess capital to its parent to ensure that DBL could effect an orderly winddown, protecting DBL's 30,000 customer accounts with \$5 billion in assets.

With its other options closed off, Drexel defaulted on approximately \$100 million of loans on February

13, 1990, and sought relief under Chapter 11. To stem concerns about the financial solvency of DBL, the SEC and the NYSE issued a statement noting that they were carefully monitoring the liquidity of Drexel and DBL and that financial information provided by DBL indicated it had positive net worth and remained in capital compliance. In the days that followed, the oversight group concentrated on facilitating the liquidation of DBL's positions and on pursuing the prompt transfer of DBL's customer accounts to other broker-dealers.

DBL began to liquidate a large percentage of its inventory and matched-book positions, and GSI liquidated its inventory of government securities. Despite assurances from the regulators, financial markets were disrupted. One of the major sources of risk in clearing and settlement systems for most financial instruments is the time lag between the delivery of instruments and final payment. As Drexel attempted to liquidate its positions in securities, foreign exchange, and commodities markets, this lag became a problem. Potential counterparties were unwilling to surrender securities to Drexel in advance of payment since they were concerned about the quality of DBL's collateral and the possibility that DBL might lack the resources necessary to complete the transaction. Some firms refused to deal with DBL at all. Those that did used extreme caution in their transactions. A logjam developed in the exchange of securities, foreign exchange, and cash that slowed the unwinding of positions. Third parties were affected by these disruptions, and the major electronic payment systems, FedWire and CHIPS, were forced to remain open longer than usual.

In Drexel's case there was a type of intraorganizational "contagion effect," just as the Fed had feared. Although the regulated subsidiaries were solvent, they had difficulties operating in the market under routine conventions. But the effect was minimal. Although delays occurred, DBL and GSI ultimately were able to liquidate their positions and to meet their payment obligations. The winding down of Drexel, an institution whose size and wholesale business would almost surely have led regulators to deem it "too big to fail" if it were a bank, occurred with no adverse consequences for its retail customers and at no cost to taxpayers.

The collapse of Drexel did focus attention on some clear weaknesses in the financial system—weaknesses that both regulators and the private sector have been working to correct. For example, recently instituted changes in the operation of the large-

dollar electronic payment systems have significantly reduced risk to the Fed and to the banking system from the sudden collapse of a major financial institution. As for clearing and settlement systems, a committee of the Group of Thirty recently developed standards for the major countries to improve efficiency and reduce risk in the world's financial network. Its recommendations include establishing clearing corporations and central securities depositories to act as intermediaries between trading parties, shortening settlement times and requiring payment in "same day" funds on settlement day, encouraging trade netting systems where feasible, and moving to book entry rather than paper-based systems for securities handling. These recommendations, many of which are already being implemented, provide a more focused and efficient approach for dealing with systemic risk than blanket protections for so-called "too big to fail" financial institutions.

Another lesson is that bank holding company regulation and supervision are unnecessary to protect the safety and soundness of a bank and other functionally regulated subsidiaries. When Drexel got in trouble, the functional regulators of DBL and GSI successfully cooperated to protect the safety and soundness of the regulated subsidiaries by restricting their ability to upstream funds to their faltering parent and unregulated affiliates. Ongoing regulation and supervision of the holding company were not necessary to accomplish this public policy goal. Restrictions on the activities of bank holding companies are particularly difficult to justify on the grounds of protecting the safety and soundness of bank subsidiaries. The wide range of activities in which Drexel and its unregulated subsidiaries were engaged around the world did not inhibit the functional regulators of DBL and GSI from taking steps to protect these entities.

The functional regulators of a holding company's subsidiaries may need to have information about the financial condition of the parent and affiliates so that prompt action can be taken in the event their situations deteriorate. The Market Reform Act, enacted in October 1990, gives the SEC new authority to monitor the financial condition of the affiliates and parent holding companies of broker dealers. This type of authority is a much less intrusive approach to ensuring the safety and soundness of banks and other federally regulated entities than sweeping restrictions on holding company activities and other forms of regulation.

In sum, Drexel's demise offers important reasons

to institute major changes in the way bank holding companies are regulated, supervised, and permitted to fail. It shows that the regulators' "too big to fail" doctrine is rapidly becoming obsolete as the technology for dealing with risk in the financial system improves. It also shows that the focus of regulators' efforts to protect the safety and soundness of banks should be on the bank itself, not on bank holding companies. Bank regulators may need to have adequate information about the financial condition of the parent holding company and bank affiliates, and they may need the authority, which they now have, to restrict affiliate transactions when a bank's safety and soundness are threatened. But they do not need their far-reaching and intrusive authority to determine appropriate financial arrangements and activities of bank holding companies.

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an implicit threat of a lawsuit by the Environmental Defense Fund (EDF) and subsequent discussions between McDonald's and these champions of the Earth, the packaging change was announced. This was advertised as a great triumph for the environment and an important contribution toward a solution for the "trash crisis." Puff pieces in major newspapers trumpeted a new age of cooperation between business and the "public-interest" lobbies.

Oh, please. The very idea that a country as vast as the United States has nowhere left to put its refuse is preposterous on its face; like most "crises," that afflicting trash disposal is the result of inappropriate government policies, inefficient pricing foremost among them. Nor is the trash "crisis," such as it is, getting worse, notwithstanding popular perceptions fed by front-page "news analyses" (editorials). If anything, the long-term trend is toward improvement, since the market has powerful incentives to reduce the amount and volume—that is, the cost—of packaging and other general contributors to the total volume and weight of trash. And the historical experience is consistent with this; per capita, there is little evidence that the United States is producing more solid waste than was the case decades ago. Moreover, wealthier economies seem to produce relatively less refuse than poorer ones; the evidence suggests, for example, that an average household in Mexico City produces one-third more solid waste than does an average household in the United States.

But that is another story. What is of interest here are the purported environmental benefits flowing from McDonald's packaging decision, which was encouraged by the politicians at the EDF. What are the facts? As a generalization, the McDonald's

Self-Flagellation among the Capitalists

The eagerness with which businessmen engage in preemptive surrender to the political Left—oops, the "public interest consumer and environmental" lobbies—remains one of the mysteries of modern life. After all, businessmen surely understand the general benefits of capitalism, both normative and positive. Perhaps a bit more hidden from the view of the capitalists are the true goals of the environmental lobby, which can be summarized as an expansion in their own political power, and thus the emasculation of the private sector, that is, the destruction of those very same businessmen. This is hardly the first example of individuals' lending assistance to their own (unjustified) punishment, but the source of this self-flagellation nonetheless remains obscure.

Let us consider a recent example, to wit, the announcement by McDonald's that polystyrene foam containers for their food products are to be replaced with coated paperboard packaging. A massive disinformation campaign by part of the environmental lobby has painted polystyrene packaging as "wasteful," as an important contributor to our purported "crisis" in solid waste disposal, and as a larger symbol of the supposed indifference of capitalism to environmental degradation. Following

decision will do little to alleviate the solid-waste problem since polystyrene packaging accounts for only one-third of one percent of landfill volume and only one-tenth of one percent by weight; and the polystyrene not used inevitably will be replaced by something. Moreover, air and water pollution problems will be *exacerbated*, an outcome of no particular concern to the EDF. The Stanford Research Institute concluded in 1975, "There appears to be no supportable basis for any claim that paper-related products are superior from an environmental standpoint to plastic-related ones, including polystyrene." It is less costly to recycle polystyrene, and the production of an equal volume of paperboard consumes 3 times more wood, about 50 percent more energy, 6 times more water, and yields 300 times the volume of waste water.

Indeed, McDonald's itself in a 1990 pamphlet concluded, "[I]f the plastic products [Franklin and Associates] studied were replaced with nonplastic alternative products, total energy consumption would have to be increased by 834.2 trillion BTUs, enough energy to heat 4 million homes . . . for one year." The same Franklin and Associates study concluded that polystyrene has a slight disadvantage relative to paperboard in terms of the volume (but not the weight) of solid waste generated, but that the production of paperboard yields almost 100 percent more in terms of atmospheric emissions and waterborne effluents. Moreover, chlorofluorocarbons have not been used in polystyrene production since 1988, and while polystyrene does not degrade, little does anything else in landfills, owing to the absence of air and light.

Just as none of this was news to McDonald's, neither was it news to the EDF, which surely was aware of these and other studies. Of equal interest was the fund's opposition to McDonald's polystyrene recycling program. After establishing a pilot program over a year ago in New England, McDonald's planned to expand the program nationwide. The EDF's opposition stood in stark contrast to its loud trumpeting over the years for "recycling." After all, recycling of polystyrene increases its environmental advantages over paperboard substantially, particularly since by law paperboard used for food packaging may not contain recycled materials.

To put it more bluntly, just as the private sector had found a way to enhance environmental quality without greater regulatory intrusion and without a further display of legal and political bullying by the EDF, the environmentalists changed their tune. Greater recycling of polystyrene was no longer

acceptable. No, McDonald's now had to make headlines on the EDF's terms, and the environment be damned. After all, the environmental facts inherent in a choice between polystyrene and paperboard are not seriously in dispute, and the EDF cannot claim to have been unaware of them. Thus, ignorance does not explain their behavior. Nor are their choices consistent with an assumption that improvement in environmental quality is their central objective. No, their behavior—like that of other mainstream environmental lobbies—is consistent with a goal of increased political power, publicity, fund-raising, and long-term emasculation of the private sector.

But what explains the behavior of McDonald's? Perhaps they have come to believe that significant numbers of consumers are influenced by such charlatans as the EDF, and, accordingly, that they must play ball with them, notwithstanding the adverse consequences. Perhaps they fear the downside potential of a lawsuit in an age of expansive liability and the erosion of economic liberty and property rights; that such groups as the EDF have come to be granted standing by the courts may be regrettable, but is outside the ability of businesses to change. Or perhaps businessmen increasingly are coming to accept the political propaganda put out by consumer and environmental lobbies; with the market for corporate control under attack by politicians and other "stakeholders," such silliness may be more immune to challenge than in the past.

Whatever the source of business surrender as a strategy with which to placate the political Left, it is doomed to failure because it assumes implicitly that the stated goals of these lobbies are the same as their actual goals. Such is not the case, and once it is recognized that political goals are paramount, preemptive surrender inevitably will be exposed as an empty course. In the long run, careful analysis and a respect for facts will emerge triumphant; and the recent election defeat of numerous environmental initiatives indicates that the tide may be turning. Businessmen can defend themselves, notwithstanding a hostile media, as McDonald's did successfully before the decision to switch packaging materials. Thus, let us pray that the packaging decision was an aberration; perhaps we can attribute it to McPolitics.

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The Ivory Import Ban

When Daniel arap Moi of Kenya burned more than 2,500 elephant tusks worth an estimated \$3.6 million in July 1989, he set off a conflagration that reached far beyond the ivory trade. His action had implications for environmentalism in general, for free trade, and for the privatization movement that is now sweeping the globe.

Moi set off the blaze in Nairobi National Park to dramatize the plight of the African elephant. Poachers have been killing these gigantic beasts at such a furious clip that there is now the fear in some quarters that the species may soon become extinct.

As a result, the price of ivory has been driven higher and higher. This so-called "white gold" currently sells for some \$100 per pound. Unless something is done, the lure of profits will undoubtedly lead to still more intensive poaching, even higher ivory prices, and greater danger to the survival of the elephant. Moi set his bonfire with the hope that a worldwide ban on the importation of ivory would reverse this cycle. A trade ban that reduced demand would also lower ivory prices. With softer markets, there would be less incentive for poachers to operate.

The bonfire was clearly a public relations success. Even commentators generally receptive to the case for capitalism, privatization, and free trade have gone along with the idea as the only possible solution in this case.

Unfortunately, commercial bans and import restrictions simply do not work. *The Economist* observed when Moi lit his fire: "A much more probable effect of a ban will be to drive up the price of ivory even faster. . . . That will raise the profitability of poaching, and increase the risks poachers will take. . . . A ban will drive the ivory trade underground, making it as hard to police as cocaine smuggling from the forests of Latin America."

Nor can one claim that all of the ivory now traded is the result of theft, and that it is therefore legitimate to prohibit trading in poached ivory. According to the estimates of the conservationists themselves, only some 80 percent of the ivory traded today stems from poaching. There are large stocks of ivory already stockpiled, including unworked material as well as extant jewelry, sculptures, piano keys, billiard balls, chop sticks, and Asian signature stamps. Some of this wealth may have emanated from poaching, but most, especially that created in the past, likely has not. In addition, not all African nations have gone along with the ban proposed by



the Convention on International Trade in Endangered Species. One cannot therefore assume that if an object is made of ivory, it must be the product of poaching. Unfortunately, a trade ban covers stolen as well as legitimate property.

There is an alternative that would provide more sure protection for elephants without devaluing legitimate property. That alternative is privatization.

Privately owned animals are cared for and protected by their owners. The threat of extinction has never been even a remote threat for cows, sheep, goats, horses, dogs, or cats. Why, then, not apply this lesson to the African elephant?

The first response is that elephants are different from cows; they need much more space and huge amounts of food. What remain of the wild elephant herds range over hundreds of square miles, often failing to recognize the sanctity of national boundaries.

A requirement for wide-open spaces does not seriously undermine the case for privatization, however. In the American West of the nineteenth century, in the epoch before barbed wire, ranchers would brand their cattle and then let them run loose on the wide-open prairie. Even in this setting, ranchers who shared the common pasture actively guarded against cattle thieves. A similar approach could help protect elephants in Africa.

In addition, the fact that publicly owned elephants have been allowed to range over huge spaces does not necessarily make that the optimal arrangement. Elephants are at risk precisely because the size of the areas over which they have traditionally roamed makes it difficult for the public sector to safeguard against human predators. Other options do exist. Private owners might follow the pattern set by a farmer in Texas who shelters rhinos on 80 acres of his 2,200 acre ranch. In addition, the Nature Con-

servancy has established a large system of private nature preserves on more than 1.5 million acres in more than a thousand locations. Further, numerous zoos keep elephants and other large animals healthy on far less terrain than that commonly used in Africa—not in small cages, but in large natural habitats varying from 100 to 700 acres. Instead of picturing the commercialized, privatized elephant unhappily hemmed in and limited to a small stall or barn, one can envision a wide open “Disneyland” for elephants.

Adequate food supplies should present less of a problem for privately owned elephants than for publicly owned animals. The ranchers, zookeepers, and private-sector environmentalists who own elephants will find it in their interest to provide the needed quantities of food to keep their elephants healthy.

Finally, there is the argument that it is extremely expensive, if not simply impossible, to fence in elephants. But this, too, fails. Zoos manage to keep their charges from wandering from their assigned habitats. And Texas farmer Calvin Bentsen has installed a “six-bar iron fence” strong enough to withstand the best efforts of “a hard-charging 2,500-lb. bull rhinoceros named Macho.” Private elephant entrepreneurs in Africa and elsewhere ought to be able to come up with something similar for their recalcitrant beasts.

It is difficult at first to imagine the elephant in the role of a barnyard animal because it does not give milk, lay eggs, or provide wool. Nor do we eat elephant meat. But the highly valuable tusks alone, to say nothing of the leather, would provide incentives to preserve and protect the elephant. Owners might also exploit tourists’ interest in elephants through picture-taking safaris, controlled hunting, and sightseeing as a further means of paying for the animals’ upkeep.

Let us consider one last objection. It is claimed that the poaching problem is so serious that unless something is done immediately, no elephants will be left to be privatized. Meanwhile, the process of turning over the elephants and the land they inhabit to private enterprise in Africa would take months, if not years. Therefore, opponents conclude that although privatization might be a good idea in theory, it will not work in practice.

In the first place, a ban on the ivory trade will also take months, if not years, for its effects to be felt. Even more important, this argument concedes in effect that privatization is desirable, but because it cannot be carried out instantaneously, the state

must remain in control. On such grounds, one could object to *all* cases of deregulation and privatization. The fact that reform may take time does not imply that we should forego a superior solution rather than undertake the effort necessary to ensure the survival of the elephant.

Economically, the case for elephant privatization is airtight, and it could be accomplished in a matter of weeks if the political will were there. All that needs to be done is to set up an auction of, say, 100-elephant, 10-square-mile parcels. If this is not the optimal configuration, market trading will move the economy in the necessary direction. By all means, let the government do what it can in the meantime to preserve the elephant, but the best long-run solution is still privatization.

None of the arguments against elephant privatization can withstand close scrutiny. Despite pursuing a worthwhile goal, Daniel arap Moi and the Convention on International Trade in Endangered Species are traveling a dead-end road in seeking a worldwide ban on the ivory trade. Indeed, an ivory ban could actually make the situation worse.

It is true that “the African elephant’s misfortune is its tusks,” but only in the present public ownership situation. Under a system of private ownership, the elephants’ tusks would become a blessing, as private owners would care for and protect their elephants and guarantee the survival of the species to ensure future profits from the sale of the ivory. Moi’s tusk bonfire captured the imagination of the world. Now let us encourage adoption of the policies that will ensure the survival of the animals. Privatize the elephants.

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Competing Perspectives on Taxes and the Environment

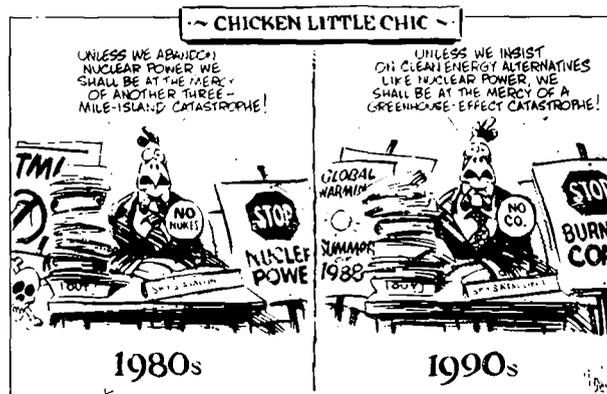
A sharp difference has developed between the perspectives of federal politicians and the nation’s voters on two important issues: taxes and the environment. In late October, for example, Congress approved a complex package of new taxes that will increase federal revenues by about one-half of one percent of GNP. During the same hectic period, Congress also approved a comprehensive revision of the Clean Air Act that will also cost about one-half of

one percent of GNP. Each of these measures, whatever their benefits, will reduce economic growth and the international competitiveness of American products.

Only a few days later, however, voters across the country expressed a massive protest against higher taxes and increased environmental regulation. Tax issues were important in defeating the gubernatorial candidate of the incumbent party in Kansas, Nebraska, Minnesota, Michigan, Ohio, Massachusetts, and Florida. A concern about higher taxes also contributed to the sharply reduced margins for Gov. Mario Cuomo in New York and Sen. William Bradley in New Jersey, both running against weak opponents, and the approval of term-limitation amendments in California, Colorado, and (previously) Oklahoma. American elections seldom provide such a uniform signal of voter sentiment.

On election day voters across the country also defeated all but a few of around 200 environmental measures on the ballot, most important, the nearly two-to-one vote against the massive Big Green initiative in California. On these issues as well, voters conveyed a strong signal that the perceived benefits of tighter environmental regulation are lower than the additional costs.

What explains this massive difference between the perspectives of federal politicians and voters? One explanation is that special interests are more effective in influencing legislatures than in persuading voters. Another explanation is that voters have



a clearer sense that they will pay the costs of higher state taxes and regulation, compared with the less clear distribution of the costs of federal taxes and regulation. As a consequence, the rhetoric of Washington is that of "responsibility," "unmet needs," and the importance of educating the public to accept higher taxes and regulation. And American voters are increasingly alienated from a political system that does not seem responsive to even a broad popular protest against higher taxes and regulation. Given the huge political advantage of congressional incumbents, the prospect for resolving this difference in perspectives is not encouraging. The test will be whether federal politicians learn anything from the 1990 elections and, if they do not, how the voters react in 1992.

W.N.