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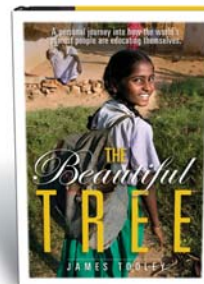

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Cato Policy Report
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Did Deregulation Cause the Financial Crisis?

BY MARK A. CALABRIA

The growing narrative in Washington is that a decades-long unraveling of the regulatory system allowed and encouraged Wall Street to excess, resulting in the current financial crisis. Left unchallenged, this narrative will likely form the basis of any financial reform measures. Having such measures built on a flawed foundation will only ensure that future financial crises are more frequent and severe.

ROLLING BACK THE REGULATORY STATE?

Although it is the quality and substance of regulation that has to be the center of any debate regarding regulation's role in the financial crisis, a direct measure of regulation is the budgetary dollars and staffing levels of the financial regulatory agencies. In a Mercatus Center study, Veronique de Rugy and Melinda Warren found that outlays for banking and financial regulation increased from only $190 million in 1960 to $1.9 billion in 2000 and to more than $2.3 billion in 2008 (in constant 2000 dollars).

Focusing specifically on the Securities and Exchange Commission—the agency at the center of Wall Street regulation—budget outlays under President George W. Bush increased in real terms by more than 76 percent, from $357 million to $629 million (2000 dollars).

However, budget dollars alone do not always translate into more cops on the beat—all those extra dollars could have been spent on the SEC's extravagant new headquarters building. In fact most of the SEC's expanded budget went into additional staff, from 2,841 full-time equivalent employees in 2000 to 3,568 in 2008, an increase of 26 percent. The SEC's 2008 staffing levels are more than eight times that of the Consumer Product Safety Commission, for example, which reviews thousands of consumer products annually.

Comparable figures for bank regulatory agencies show a slight decline from 13,310 in 2000 to 12,190 in 2008, although this is driven completely by reductions in staff at the regional Federal Reserve Banks, resulting from changes in their check-clearing

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After eight years as a senior economist at the Senate Committee on Banking, Housing, and Urban Affairs, **MARK CALABRIA** joined the Cato Institute in April as director of financial regulation studies.

Venezuela's government did not want its citizens hearing the Cato Institute's message of freedom. Officials under Hugo Chávez sought to shut down a recent session of Cato University in the country, but failed to keep young Venezuelans from learning about the benefits of capitalism and individual liberty. Here, Venezuelan Chavistas protest Cato's activities in the country. **PAGE 12**

BY DAVID BOAZ

"President Obama promised to end the war in Iraq and to cut federal spending on net."

Editorial

Stop the War, Stop the Spending

President Obama is keeping the wrong promises. He's working very hard to keep his promises to tax more, spend more, and regulate more.

But he also promised to end the war in Iraq and to cut federal spending on net, and those promises were left behind when they closed the campaign headquarters.

Hundreds of thousands of Americans turned out on April 15 to protest the bailouts, the $787 billion stimulus package, and Obama's budget. Maybe some day soon antiwar activists will realize that the war is still going on and will hold some rallies too.

Obama's broken promises give libertarians a chance to get out in front with a "Stop the War, Stop the Spending" movement.

Take the war in Iraq. Barack Obama rose to prominence as a vigorous opponent of the war. His antiwar speech in Chicago in October 2002 was the keystone of his campaign. With most of his Democratic opponents having voted for the war as senators, Obama campaigned as the only true antiwar candidate. In the thick of the primaries, he declared, "I opposed this war in 2002. I will bring this war to an end in 2009. It is time to bring our troops home." That's how he drew the support of the Democratic left and then a broader audience of Americans who had turned against the floundering war.

But later in the campaign, after the primaries, he backed away from his commitment to end the war in his first year. He said he would "redeploy our combat brigades at a pace that would remove them in 16 months."

Soon after taking office, he essentially reaffirmed that plan. But it turned out that after about 18 more months of combat, until the end of summer 2010, the president intends to keep some 50,000 troops in Iraq until at least 2012. That's a far cry from "I will bring this war to an end in 2009. It is time to bring our troops home."

As for spending, during the campaign Obama pandered to interest groups with promises of taxpayer dollars—money for college loans, "green energy," national health insurance, higher teacher pay, more Medicaid, subsidies for homeowners, and so on. During the campaign Hillary Clinton said, "I have a million ideas. The country can't afford them all." So did Obama, and it's not clear that he understood that latter point.

But he also promised to crack down on earmarks and pork-barrel spending. He promised that he would "reinstate pay-as-you-go (PAYGO) budget rules, so that new spending or tax cuts are paid for by spending cuts or new revenue elsewhere." And most significantly, in the third presidential debate, when those last few undecided voters were watching intently, Obama declared, "We've been living beyond our means and we're going to have to make some adjustments. Now, what I've done throughout this campaign is to propose a net spending cut."

That's right. He promised a net spending cut.

And what did taxpayers get? Right out of the box, a $787 billion kitchen-sink "stimulus" spending bill—on top of a federal budget that had increased by a trillion dollars under George W. Bush even before the bailout bonanzas of late 2008. A $1.8 trillion deficit in 2009, larger than the entire budget in President Clinton's last year. The national debt skyrocketing to 67 percent of GDP. A permanent 25 percent increase in the size of nondefense spending as a percentage of GDP. And all of these figures are based on the dubious assumptions that "temporary" spending programs will actually expire, that discretionary spending growth will be much lower after 2012 than it is now, that national health care won't cost more than expected, and so on. No wonder taxpayers turned out on April 15.

Now some critics say, "Where were these spending opponents during the spendthrift years?" And they have a point. Too many conservatives and Republicans went along with the Bush-Lott-Hastert-DeLay spendathon. Not the Cato Institute, of course, which produced a steady stream of books, reports, seminars, and op-eds deploring the GOP spending record and calling for cuts. But the fact is that while Bush was the biggest spender since Lyndon Johnson, Obama is leaving him in the dust. Bush almost doubled the national debt, to $10 trillion. Obama's budget proposes a national debt of $17 trillion by 2013 and $23 trillion in 10 years.

We should also note that as bad as our current spending is, the real budget problem is the looming cost of entitlements programs. As the Social Security trustees reported in May, the total unfunded indebtedness of Social Security and Medicare comes to $106.4 trillion. Paying that off would require an 81 percent increase in everyone's income taxes in perpetuity. Until we're willing to confront those long-term promises that we can't keep, we're not really dealing with the spending problem.

Millions of Americans are tired of the war and worried about soaring federal spending. Somebody should give them a rallying point: Stop the War, Stop the Spending.

Cato welcomes new scholars

Miron, Calabria Strengthen Financial Studies

Author and Soviet-era political dissident **VLADIMIR BUKOVSKY** has joined the Cato Institute as a senior fellow. He will continue to write and speak on his experiences fighting Soviet tyranny and the dangers of repressive regimes.

Bukovsky spent 12 years in Soviet prisons, labor camps, and forced-treatment psychiatric hospitals as punishment for his anti-communist activities. He later smuggled documents out of Russia and has worked to preserve archives on Soviet brutality. He has written several books about his experiences, including *To Build a Castle: My Life as a Dissenter* (1978), *Soul of Man under Socialism* (1979), *and Soviet Hypocrisy and Western Gullibility* (1987).

Though he settled in Cambridge, England, in 1976, Bukovsky visited Moscow after the fall of communism in 1991 and has remained an outspoken voice for democracy there. His more recent writings have criticized former President Vladimir Putin for trampling the Russian constitution and aggressively expanding his own political power.

Bukovsky was a founder of Committee 2008, whose mission was to ensure a free and fair Russian presidential election. He gained widespread support as a presidential aspirant himself, though his candidacy ultimately was not certified by the pro-Kremlin Central Election Commission.

JEFFREY MIRON, director of undergraduate studies at Harvard's Department of Economics, has joined the Cato Institute as a senior fellow.

Miron will help Cato's economic team promote dynamic market capitalism and economic freedom through media appearances, policy analyses, and outreach to the academic community. He is the author of *Drug War Crimes: The Consequences of Prohibition and The Economics of Seasonal Cycles,* in addition to numerous journal articles.

Miron will remain at Harvard's economics department. Prior to joining Harvard, he served as chairman of the Department of Economics at Boston University. Miron received his Ph.D. in economics from the Massachusetts Institute of Technology.

MARK CALABRIA, a veteran staff member of the Senate Committee on Banking, Housing and Urban Affairs, has joined the Cato Institute as director of financial regulation studies.

"I join Cato with a great sense of excitement and urgency," Calabria said. "Cato has long been a strong, and sometimes the only, voice for expanding and protecting individual choice. We are confronted with stark choices regarding the regulation of our financial markets: whether to expand the role of politics in deciding who will get credit and which institutions will fail. In a time when markets and freedom are being questioned and attacked, Cato's mission of understanding the impact of government proposals is all the more necessary."

In addition to his work on Capitol Hill, Calabria served as deputy assistant secretary for consumer and regulatory affairs, U.S. Department of Housing and Urban Development, and was also senior economist at the National Association of Realtors and a fellow at Harvard's Joint Center for Housing Studies. Calabria earned his Ph.D. in economics from George Mason University.

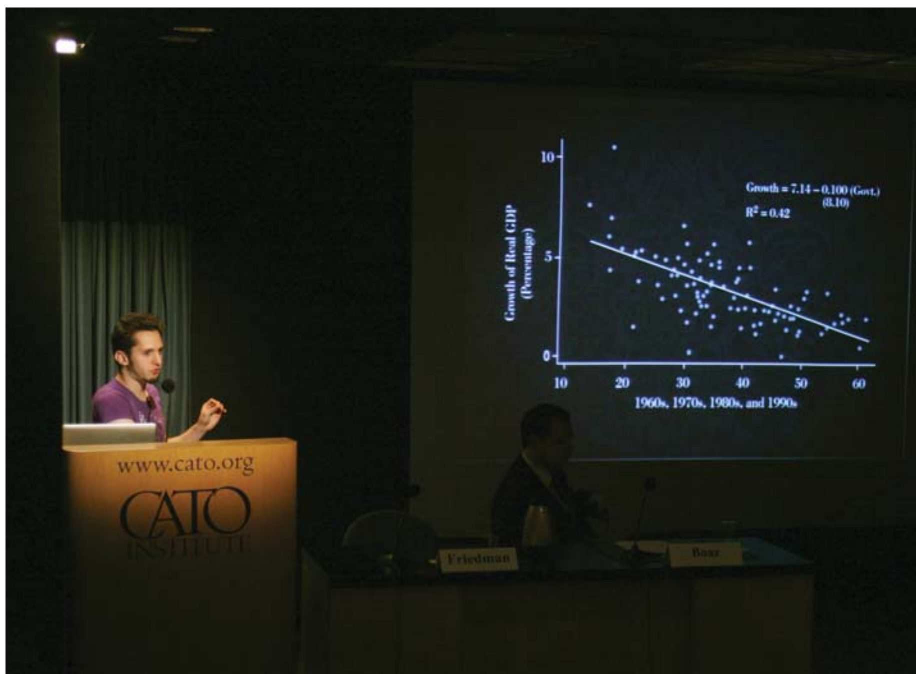
Cato News Notes

Cato research fellow BENJAMIN FRIEDMAN is coeditor with Harvey Sapolsky and Brendan Rittenhouse Green of *US Military Innovation since the Cold War: Creation without Destruction*, just published by Routledge. The book explains how the U.S. military reacted to the "Revolution in Military Affairs" and failed to innovate its organization or doctrine to match the technological breakthroughs it brought about. Friedman wrote or coauthored four chapters for the book, which is available from the publisher or from online book services. Friedman's Cato paper, "Learning the Right Lessons from Iraq" (coauthored with Sapolsky and Christopher Preble), has been included in the 7th edition of the classic textbook *Use of Force: Military Power and International Politics*, edited by Robert J. Art and Kenneth Waltz.

***Roll Call*, a newspaper widely read on Capitol Hill, reviewed a Shakespeare parody performed by members of Congress in a benefit for the Shakespeare Theatre Company. The reviewer wrote that one of the best lines "came from Sen. Roger Wicker (R-Miss.), who put in an enthusiastic turn on the boards as a reflexively conservative Sen. Right. 'My PDA has a direct line to the CATO INSTITUTE,' he declared, as he searched for talking points on a bill."**

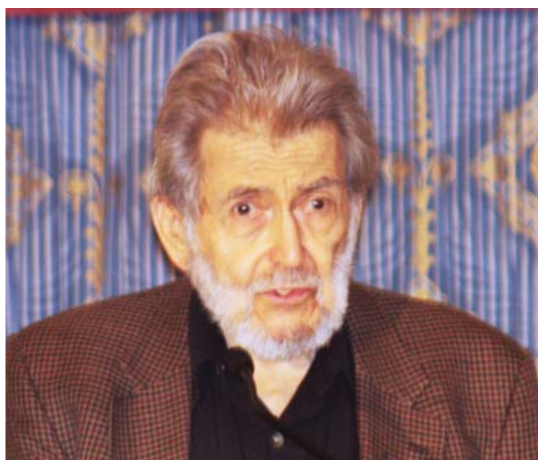
Reviewing news coverage of President Obama's first 100 days, *New York* magazine awarded the title "Most Disdainful American Coverage" to Cato vice president GENE HEALY'S *Washington Examiner* column "Obama's 100-day Power Grab."

JAMES BARTHOLEMEW, columnist for the *Daily Telegraph* and the *Daily Mail,* discussed his book *The Welfare State We're In*—which Milton Friedman called "a devastating critique"—at a Cato Book Forum on May 18. Bartholemew argues that the welfare state in Britain has resulted in a generation of badly educated and dependent citizens, and has done more harm than good.



PATRI FRIEDMAN, executive director of the Seasteading Institute, tells a Cato Policy Forum audience on April 7 that libertarian efforts to improve government have been unsuccessful and that "exiting" from governments—such as with self-sufficient deep-sea platforms free of national governments—would better enable individuals to live in the free societies they want. Above left, he argues that economic growth has been steadily declining, demonstrating the impracticality of central governments. At right he talks with syndicated columnist JAMES PINKERTON, a former aide to Presidents Ronald Reagan and George H. W. Bush.

PROFESSOR MEIR KOHN of Dartmouth College speaks at a Cato luncheon on April 29 about his theory of economic progress and development in history, using examples from Europe and China over the last few centuries. Kohn finds that a centuries-long conflict between commerce and predation explains the economic history of both regions.



At an April 30 Cato seminar in New York, an overflow crowd of more than 300 people heard from an all-star lineup of speakers. Top right, investment adviser PETER SCHIFF warned that the Federal Reserve's actions would result in surging inflation. Below, noted civil libertarian and Cato senior fellow NAT HENTOFF discussed current threats to freedom of speech. FREEMAN DYSON, best known for his work in quantum electrodynamics and "applied elegant mathematics," offered some "heretical" thoughts on global warming and the dangers of nuclear weapons. Cato senior fellow Pat Michaels also spoke on the topic of his new book, *Climate of Extremes: Global Warming Science They Don't Want You to Know.*

Continued from page 1

activities (mostly now done electronically) and at the FDIC, as its resolution staff dealing with the bank failures of the 1990s was wound down. Other banking regulatory agencies, such as the Comptroller of the Currency —which oversees national banks like Citibank—saw significant increases in staffing levels between 2000 and 2008.

Another measure of regulation is the absolute number of rules issued by a department or agency. The primary financial regulator, the Department of the Treasury, which includes both the Office of the Comptroller of the Currency and the Office of Thrift Supervision, saw its annual average of new rules proposed increase from around 400 in the 1990s to more than 500 in the 2000s. During the 1990s and 2000s, the SEC issued about 74 rules per year.

Setting aside whether bank and securities regulators were doing their jobs aggressively or not, one thing is clear—recent years have witnessed an increasing number of regulators on the beat and an increasing number of regulations.

GRAMM-LEACH-BLILEY

Central to any claim that deregulation caused the crisis is the Gramm-Leach-Bliley Act. The core of Gramm-Leach-Bliley is a repeal of the New Deal-era Glass-Steagall Act's prohibition on the mixing of investment and commercial banking. Investment banks assist corporations and governments by underwriting, marketing, and advising on debt and equity issued. They often also have large trading operations where they buy and sell financial securities both on behalf of their clients and on their own account. Commercial banks accept insured deposits and make loans to households and businesses. The deregulation critique posits that once Congress cleared the way for investment and commercial banks to merge, the investment banks were given the incentive to take greater risks, while reducing the amount of equity they are required to hold against any given dollar of assets.

But there are questions about how much impact the law had on the financial markets and whether it had any influence on the current financial crisis. Even before its passage, investment banks were already allowed to trade and hold the very financial assets at the center of the financial crisis: mortgage-backed securities, derivatives, credit-default swaps, collateralized debt obligations. The shift of investment banks into holding substantial trading portfolios resulted from their increased capital base as a result of most investment banks becoming publicly held companies, a structure allowed under Glass-Steagall.

> "Recent years have witnessed an increasing number of regulators on the beat and an increasing number of regulations."

Second, very few financial holding companies decided to combine investment and commercial banking activities. The two investment banks whose failures have come to symbolize the financial crisis, Bear Stearns and Lehman Brothers, were not affiliated with any depository institutions. Rather, had either Bear or Lehman possessed a large source of insured deposits, they would likely have survived their short-term liquidity problems. As former president Bill Clinton told *BusinessWeek* in 2008, "I don't see that signing that bill had anything to do with the current crisis. Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill."

Gramm-Leach-Bliley has been presented by both its supporters and detractors as a revolution in financial services. However, the act itself had little impact on the trading activities of investment banks. The off-balance-sheet activities of Bear and Lehman were allowable prior to the act's passage. Nor did these trading activities undermine any affiliated commercial banks, as Bear and Lehman did not have affiliated commercial banks. Additionally, those large banks that did combine investment and commercial banking have survived the crisis in better shape than those that did not.

DID THE SEC DEREGULATE INVESTMENT BANKS?

One of the claimed "deregulations" resulting from the mixing of investment and commercial banking was the increase in leverage by investment banks allowed by the SEC. After many investment banks became financial holding companies, European regulators moved to subject European branches of these companies to the capital regulations dictated by Basel II, a set of recommendations for bank capital regulation developed by the Basel Committee on Banking Supervision, an organization of international bank regulators. In order to protect its turf from European regulators, the SEC implemented a similar plan in 2004.

However the SEC's reduction in investment bank capital ratios was not simply a shift in existing rules. The SEC saw the rule as a movement beyond its traditional investor protection mandates to one overseeing the entire operations of an investment bank. The voluntary alternative use of Basel capital rules was viewed as only a small part of a greatly increased system of regulation, as expressed by SEC spokesman John Heine: "The Commission's 2004 rule strengthened oversight of the securities markets, because prior to their adoption there was no formal regulatory oversight, no liquidity requirements, and no capital requirements for investment bank holding companies."

The enhanced requirements gave the SEC broader responsibilities in terms of the prudential supervision of investment banks and their holding companies.

DERIVATIVES AS FINANCIAL MISCHIEF

After Gramm-Leach-Bliley, the most common claim made in support of blaming deregulation is that both Congress and regulators ignored various warnings about the risks of derivatives, particularly credit default swaps, and chose not to impose needed regulation. In 2003, Warren Buffett called derivatives "weapons of mass financial destruction," and warned that the concentration of derivatives risk in a few dealers posed "serious systemic

problems." Buffett was not alone in calling for increased derivatives regulation.

But would additional derivatives regulation have prevented the financial crisis?

During her chairmanship of the Commodity Futures Trading Commission Brooksley Born published a concept paper outlining how the CFTC should approach the regulation of derivatives. Her suggestions were roundly attacked both by members of the Clinton administration, including Robert Rubin and Larry Summers, and by the leading members of the CFTC oversight committees on Capitol Hill.

Foremost among Born's suggestion was the requirement that derivatives be traded over a regulated exchange by a central counterparty, a proposal currently being pushed by Treasury secretary Timothy Geithner. Currently most derivatives are traded as individual contracts between two parties, each being a counterparty to the other, with each party bearing the risk that the other might be unable to fulfill its obligations under the contract. A central counterparty would stand between the two sides of the derivatives contract, guaranteeing the performance of each side to the other. Proponents of this approach claim a central counterparty would have prevented the concentration of derivatives risk into a few entities, such as AIG, and would have prevented the systemic risk arising from AIG linkages with its various counterparties.

The most basic flaw in having a centralized counterparty is that it does not reduce risk at all, it simply aggregates it. It also increases the odds of a taxpayer bailout, as the government is more likely to step in and back a centralized clearinghouse than to rescue private firms. In the case of AIG, Federal Reserve vice chairman Donald Kohn told the Senate Banking Committee that the risk to AIG's derivatives counterparties had nothing to do with the Fed's decision to bail out AIG and that all its counterparties could have withstood a default by AIG. The purpose of a centralized clearinghouse is to allow users of derivatives to separate the risk of the derivative contract from the default risk of the issuer of that contract in instances where the issuer is unable to meet its obligations. Such an arrangement would actually increase the demand and usage of derivatives.

> "The value of derivatives is that they allow the separation of various risks and the transfer of those risks to the parties best able to bear them."

Proponents of increased regulation of derivatives also overlook the fact that much of the use of derivatives by banks is the direct result of regulation, rather than the lack of it. To the extent that derivatives such as credit default swaps reduce the risk of loans or securities held by banks, Basel capital rules allow banks to reduce the capital held against such loans.

One of Born's proposals was to impose capital requirements on the users of derivatives. That ignores the reality that counterparties already require the posting of collateral when using derivatives. In fact, it was not the failure of its derivatives position that led to AIG's collapse but an increase in calls for greater collateral by its counterparties.

Derivatives do not create losses, they simply transfer them; for every loss on a derivative position there is a corresponding gain on the other side; losses and gains always sum to zero. The value of derivatives is that they allow the separation of various risks and the transfer of those risks to the parties best able to bear them. Transferring that risk to a centralized counterparty with capital requirements would have likely been no more effective than was aggregating the bulk of risk in our mortgages markets onto the balance sheets of Fannie Mae and Freddie Mac. Regulation will never be a substitute for one of the basic tenets of finance: diversification.

CREDIT RATING AGENCIES

When supposed examples of deregulation cannot be found, advocates for increased regulation often fall back on arguing that a regulator's failure to impose new regulations is proof of the harm of deregulation. The status of credit rating agencies in our financial markets is often presented as an example of such.

Credit rating agencies can potentially serve as an independent monitor of corporate behavior. That they have often failed in that role is generally agreed upon; why they've failed is the real debate. Advocates of increased regulation claim that since the rating agencies are paid by the issuers of securities, their real interest is in making their clients happy by providing the highest ratings possible. In addition they claim that the rating agencies have used their "free speech" protections to avoid any legal liability or regulatory scrutiny for the content of their ratings.

The modern regulation of credit rating agencies began with the SEC's revision of its capital rules for broker-dealers in 1973. Under the SEC's capital rules, a broker-dealer must write down the value of risky or speculative securities on its balance sheet to reflect the level of risk. In defining the risk of held securities, the SEC tied the measure of risk to the credit rating of the held security, with unrated securities considered the highest risk. Bank regulators later extended this practice of outsourcing their supervision of commercial bank risk to credit rating agencies under the implementation of the Basel capital standards.

The SEC, in designing its capital rules, was concerned that, in allowing outside credit rating agencies to define risk, some rating agencies would be tempted to simply sell favorable ratings, regardless of the true risk. To solve this perceived risk, the SEC decided that only Nationally Recognized Statistical Rating Organizations would have their ratings recognized by the SEC and used for complying with regulatory capital requirements. In defining the qualifications of an NRSRO, the SEC deliberately excluded new entrants and grandfathered existing firms, such as Moody's and Standard and Poor's.

In trying to address one imagined problem, a supposed race to the bottom, the SEC succeeded in creating a real problem, an entrenched oligopoly in the credit ratings industry. One result of this oligopoly is that beginning in the 1970s, rating agencies moved away from their historical practice of marketing and selling ratings largely to investors,

toward selling the ratings to issuers of debt. Now that they had a captive clientele, debt issuers, the rating agencies quickly adapted their business model to this new reality.

The damage would have been large enough had the SEC stopped there. During the 1980s and 1990s, the SEC further entrenched the market control of the recognized rating agencies. For instance, in the 1980s the SEC limited money market funds to holding securities that were investment grade, as defined by the NRSROs. That requirement was later extended to money market fund holdings of commercial paper. Bank regulators and state insurance commissioners followed suit in basing their safety and soundness regulations on the use of NRSRO-approved securities.

The conflict of interest between raters and issuers is not the result of the absence of regulation, it is the direct and predictable result of regulation. The solution to this problem is to remove the NRSROs' monopoly privileges and make them compete in the marketplace.

PREDATORY LENDING OR PREDATORY BORROWING?

As much of the losses in the financial crisis have been concentrated in the mortgage market, and in particularly subprime mortgage-backed securities, proponents of increased regulation have argued that the financial crisis could have been avoided had federal regulators eliminated predatory mortgage practices. Such a claim ignores that the vast majority of defaulted mortgages were either held by speculators or driven by the same reasons that always drive mortgage default: job loss, health care expenses, and divorce.

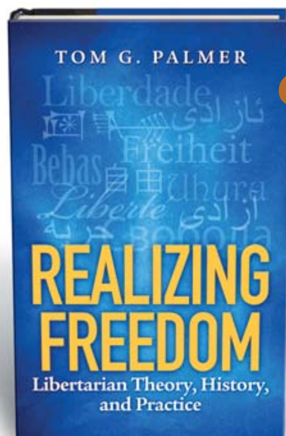
The mortgage characteristic most closely associated with default is the amount of borrower equity. Rather than helping to strengthen underwriting standards, the federal government has led the charge in reducing them. Over the years, the Federal Housing Administration reduced its down-payment requirements, from requiring 20 percent in the 1930s to the point today that one can get an FHA loan with only 3.5 percent down.

The predatory lending argument claims that borrowers were lured into unsustainable loans, often due to low teaser rates, which then defaulted en masse, causing declines in home values, which led to an overall decline in the housing market. For this argument to hold, the increase in the rate of foreclosure would have to precede the decline in home prices. In fact, the opposite occurred, with the national rate of home price appreciation peaking in the second quarter of 2005 and the absolute price level peaking in the second quarter of 2007; the dramatic increase in new foreclosures was not reached until the second quarter of 2007. While some feedback between prices and foreclosures is to be expected, the evidence supports the view that initial declines in price appreciation and later absolute declines in price led to increases in foreclosures rather than unsustainable loans leading to price declines.

Normally one would expect the ultimate investors in mortgage-related securities to impose market discipline on lenders, ensuring that losses stayed within expectations. Market discipline began to breakdown in 2005 as Fannie Mae and Freddie Mac became the largest single purchasers of subprime mortgage-backed securities. At the height of the market, Fannie and Freddie purchased over 40 percent of subprime mortgage-backed securities. These were also the same vintages that performed the worst; subprime loans originated before 2005 have performed largely within expectations. Fannie and Freddie entering this market in strength greatly increased the demand for subprime securities, and as they would ultimately be able to pass their losses onto the taxpayer, they had little incentive to effectively monitor the quality of underwriting.

CONCLUSION

The past few decades have witnessed a significant expansion in the number of financial regulators and regulations, contrary to the widely held belief that our financial market regulations were "rolled back." While many regulators may have been short-sighted and over-confident in their own ability to spare our financial markets from collapse, this failing is one of regulation, not deregulation. When one scratches below the surface of the "deregulation" argument, it becomes apparent that the usual suspects, like the Gramm-Leach-Bliley Act, did not cause the current crisis and that the supposed refusal of regulators to deal with derivatives and "predatory" mortgages would have had little impact on the actual course of events, as these issues were not central to the crisis. To explain the financial crisis, and avoid the next one, we should look at the failure of regulation, not at a mythical deregulation. ■



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Money, Markets, and the State

Do our current financial troubles result from bad monetary policy and an abandonment of the gold standard? Benn Steil, director of international economics at the Council on Foreign Relations, and Manuel Hinds, former finance minister of El Salvador, discussed this question at a Cato Book Forum for their book, *Money, Markets, and Sovereignty*, on May 19, 2009. At a Cato Book forum a month earlier, on April 17, George Selgin, professor of economics at West Virginia University and author of *Good Money*, offered his thoughts on the roots of modern monetary policy and the power of private currency.

BENN STEIL: How do we account for the fact that every five years or so there's a major currency crisis and we're unable to develop any coherent response to it? In our book, we point out that globalization today is exceptionally unusual. If you look at earlier periods of globalization, particularly the late 19th century, what you see is that ideas of free trade went side by side with the idea of a universal monetary standard. So it's not coincidental that in the late 19th century, as countries started to coalesce around the idea that free trade might be mutually beneficial, they also coalesced around the idea that we needed a universal monetary standard to facilitate this—which was the classical gold standard.

On the other hand, if you look back through history and examine periods of protectionism—such as the 18th century, when ideas of mercantilism were at the forefront—those always went side by side with the idea of monetary nationalism, that it was the ruler's prerogative to determine what money should be, how it should be valued, and what could and could not be considered money within the borders. Of course, you did have money moving back and forth across borders, but you had floating exchange rates because rulers were continually debasing their money. Money fluctuated radically in value as it crossed borders.

But here we are in the early 21st century, when you have on the one hand the most liberal global trade and investment regime we've ever seen, and on the other, the most extreme doctrine of monetary nationalism that governments have ever contrived. We've never seen a period of history like the one we've been in since 1971, where all the currencies around the world are tied to nothing of intrinsic value. They are simply conjured by governments as a manifestation of monetary sovereignty.

That we're having trouble accommodating this situation wouldn't have been surprising to an economist in the 1930s—of the right or the left, of the free market variety or the anti-market variety. We talk in the book about the views of Friedrich Hayek on the one hand and Karl Polanyi on the other, both of whom considered it absolutely obvious that in order to have free trade and safe global capital flows, you needed to have a universal monetary standard. Both of them agreed this was gold. Of course, Hayek had sympathy with the liberal international trade order and Polanyi had a lot less sympathy with it, but they both agreed that gold was absolutely necessary to free trade.

Many economists believed that once we lost this idea of a universal monetary standard, and national currencies routinely fluctuated against each other, capital flows—which in the late 19th century had been extremely stabilizing and acted as an equilibrating mechanism to bring about the quick end of crises—would actually be massively destabilizing. Every time you had any sort of banking crisis, the reaction of investors, both foreign and domestic, would be to sell the currency en masse because they wouldn't believe that the old parities would be restored. They would naturally assume that things were going to get worse.

What we are experiencing today I would argue is not actually surprising at all. It is something that was anticipated by economists of the right and left in the 1930s. It's not a fundamental flaw with the idea of globalization or the idea that we should have a liberal international trade and investment regime. It's a flaw in the system of monetary nationalism that we're currently pursuing.

MANUEL HINDS: The world faces the problem of not having a true international currency where the supply of money is not dependent on political conditions within any one country. Because there is no global currency, countries are forced to use money issued by a single country—in our case, the United States. But within the United States, the Federal Reserve isn't as concerned with what is going on in the global market for its currency as it is with internal U.S. politics. The world uses fiat money—and it could be anybody's criteria employed to determine how much of it is going to be created.

This is one way of doing things. A second would be to have a true international currency, but then who is going to determine this? Will we have a politician saying whether we have to increase the supply of money?

A third way would be to have a commodity currency like gold. We had this currency for several centuries, but it was perfected in the 19th century. The real gold standard existed between the 1880s and 1914. It has been maligned because it is a

system in which the supply of money is not something we can manage. It is unthinkable in the current time to have a currency without discretion over how much is printed. But this was the big advantage of the gold standard: it remained outside the control of any one person, it was really something that was determined by the market and the price of gold.

There are many people who are now discovering the gold standard and finding that it functioned rather well. First, it was an international system. It was accepted everywhere. It was determined by the market and had very clear rules. The central banks participated in the gold standard not because their governments decided that it was the best way of organizing international trade, but because international trade was organized in that way.

Something I would like to mention, however, is deflation. Bernanke and many other people say we need to avoid deflation, which happened with the gold standard. In the long term, the gold standard kept the price level the same, but in the very short term, there were fluctuations. The gold standard has certain mechanisms through which prices have to go down again. There was a little inflation, a little deflation, and in the very long term you had almost zero inflation. But then, for example, between 1870 and 1890, and almost reaching to 1910, there was a long world deflation in which prices went down by 25 percent. You will probably say this was the most horrible depression in the world and actually people called it a great depression, but they were talking about the great depression of prices, not of production. This was the period in which Germany and the United States became industrialized. It was one of the most progressive periods in history—and prices were going down.

When you look at the gold standard, you realize many claims about it are myths. For instance, it is a myth that it stopped growth because of inelasticity of supply. Or that it created deflation and thus led to a reduction in production. It was not like that. The problem was that the system had constrained the politicians, and so there came a moment when they decided they didn't want to follow it anymore. They wanted to have their own monetary policy. They didn't want to be part of a global system. They launched the gold exchange system, in which they started creating currency outside the strict rules of the gold standard—and the contradiction began there.

Benn Steil

"All the currencies around the world are tied to nothing of intrinsic value."

This contradiction—between a system that was not discretionary and politicians using discretionary monetary policies—created conflicts and several crises, and eventually lead to the Great Depression. After that, the Bretton Woods system was created, which was still based on gold but gave the countries certain discretion to create money.

Now we reach our current system, which started when Nixon demonetized gold in 1971. Because we have free-floating currencies, each country can decide how to trade its money. If they are creating too much money, their currency will depreciate. But then again, we hit the same problem that we had. We don't have an international currency, we use the dollar, and the dollar has a big privilege because people around the world think in dollars. If the Fed decides to reduce interest rates, others tend to reduce interest rates—and if the Federal Reserve decides to increase interest rates, interest rates will increase.

That was the case until very recently. Now you see the Federal Reserve lower interest rates and interest rates in the market go up. It is because people are starting to doubt the dollar. They are starting to buy gold again and to stop passing dollars through the financial system. In three months, the Fed more than doubled the creation of money in the U.S. and it still didn't go through to the people—to Main Street, as they say. The ability of the Federal Reserve to create monetary policy is starting to skid. It is no longer what it used to be.

If the Federal Reserve abuses its power, people will stop believing in the dollar, and they will find something else. They will find a new currency, which will be gold, or the Euro, or whatever, and that is going to be a real problem for the United States.

GEORGE SELGIN: Mismanagement of money—and mismanagement of money serious enough to cause serious economic crises—has been the rule rather than the exception so long as central banks have been in charge of managing money.

The Federal Reserve was established in 1914 ostensibly to end financial panics like the one that had broken out seven years before. Within four years of the Fed's creation, starting from what was then a very low rate of inflation, the inflation rate passed 20 percent. It was the worst inflation in U.S. history, except for that during the Civil War. Then 1920 brought the most severe deflation in U.S. history. Fortunately, there was no New Deal or stimulus package in response to that crisis, so the economy recovered within a year. But then the Fed was at it again, fueling what became the great bull market of the late 1920s. I don't have to tell you what the Fed did after that; you all presumably know the story of the great monetary contraction that started the Great Depression. Then, just as the economy was beginning to struggle to its feet in the mid 1930s, the Fed decided to double bank reserve requirements, plunging it into

depression yet again. Then came World War II with serious inflation—disguised by price controls, of course—and then . . . well, you get the general idea.

The Fed's record has been lousy throughout its existence. The same can be said for other central banks around the world. In fact, the Fed has been one of the best: the typical central bank's record has been far worse—somewhere between the Fed's and that of, say, the Reserve Bank of Zimbabwe. That's why the dollar is, relatively speaking, so popular even now.

Why do we put up with it? Why do we let governments manage money in the first place, when they routinely make such a botch job of it? The answer the central bankers give is twofold. First, and more fundamentally, they argue that only governments are trustworthy enough to issue money or that only government authorities can issue trustworthy money. They also claim that financial panics in the absence of central banks would be even *more* serious than they've been with central banks in charge.

That second argument is false on two grounds. First of all, it's empirically false, in that pre-central banking panics were not as severe, certainly not in this country, as post-central banking panics have been. The worst of the pre-Fed panics was in 1907, and all three of the panics that broke out within the first 20 years of the Fed's existence were far more serious than it. Also, the pre-Fed panics were not the result of unhindered markets, but were products of unwise and misguided government intervention in the U.S. financial system, much of it dating to the Civil War period. Canada, during the 19th century and right up to the thirties, avoided major financial crises without a central bank. It relied instead on a completely decentralized and private commercial currency system with notes issued by various large nationwide banks. It was a famously stable financial system. Regarding Great Britain, we could tell a similar story. England suffered repeated financial crises in the 19th century. Scotland managed to avoid them. England had a central bank. Scotland had a decentralized, free banking system.

The more fundamental argument given for government control of money and for the existence of central banks is the claim that only governments can be trusted to supply money. That claim dates back to ancient times. Its roots lie not in paper money, to which it's mainly applied these days, but to coinage. Ancient governments—

George Selgin

> "The Fed's record has been lousy throughout its existence. The same can be said for other central banks around the world."

kings and princes—insisted that only they could be trusted to coin money. This claim, which soon became a dogma, was the basis of the so-called "sovereign right of coinage" or the "coinage prerogative" of government. This ancient coinage prerogative is the ultimate foundation for the entire modern apparatus of government management of national money supplies, including central banking. The Federal Reserve's legal authority, for example, rests solely on Congress's constitutional power to coin money, which is just the old ancient and medieval prerogative of coinage being continued into modern times. Of course, ancient and medieval governments enjoyed many prerogatives of which modern governments have been thankfully deprived.

How is it, then, that the coinage prerogative has managed to survive intact into modern times? The answer is that people, including economists—and despite economists' general opposition to monopoly and despite their knowledge of how governments throughout history abuse their monetary powers—believe in the ancient claim that if you let the private sector coin money, you will end up with bad money. But what if this ancient claim on which all modern government regulation of money rests is wrong? What if it can be shown that the private sector, if ever given a chance to coin money, would do a better job than government? If that could be proven, it would mean that the entire legal foundation for government control of money is basically rotten.

So has there ever been a case where, somehow, despite ancient and medieval dogmas condemning the practice, coinage was left to private enterprise? If there has been, what was the outcome? Was it the case, as so many economists predict, that Gresham's Law led to bad money driving good money out of circulation?

My book tells the story of one such episode, and its title answers the question. In the 18th century, the British economy found itself without any decent coins for retail trade and wage payments. The royal mint was producing few silver coins because silver was legally undervalued. The government gave up coining copper partly because of complaints about distribution—too much in some places and none at all elsewhere—but it did so mostly because its copper coins were easy to counterfeit, and were being counterfeited aggressively. No copper and no silver, hence no money for most payments.

It's then that the private market stepped in. When the government refused, despite entreaties from entrepreneurs, to supply decent coins, the entrepreneurs themselves, beginning with major industrialists, started to strike their own coins. By the early 1790s, there were no fewer than 20 distinct private mints striking custom coins that were issued all over England and other parts of Great Britain. These supplied the bulk of the money used for wage payments and retail exchange during those crucial decades. In

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Regime attempts to shut down Cato University

Chávez Fails to Silence Cato's Message of Liberty

In May, the Cato Institute conducted another session of its successful Cato University in Caucagua, Venezuela. This time, however, the government of Hugo Chávez took exception to Cato's teaching of individual liberty and free-market, limited government principles and sent the National Guard to disrupt the event.

Prior to Cato's arrival in Venezuela, state television and online media told Venezuelans that Cato was coming to set up a training camp for young subversives, a camp at which they would be taught techniques for overthrowing Chávez.

Once the event started, the Chávez government claimed that Cato University, conducted with the help of the Venezuelan-based, classical liberal think tank, CEDICE, lacked the proper permits to operate as a university. While Cato was teaching young Venezuelans about the benefits of individual choice in a free society, a state representative of the ministry of higher education arrived, accompanied by reporters from state television and the National Guard, and harassed the conference organizers. Even after being told that Cato University was not, in fact, a university, the Chávez government did not back down. Instead, it changed its tactics, accusing Cato University of engaging in false advertising.

The government then took the step of detaining Alvaro Vargas Llosa, a Peruvian intellectual and speaker at the event. He was released after three hours by airport authorities, but only on the condition that he not speak about the political situation in Venezuela, a condition he did not adhere to.

Later, Chavistas, not officially sanctioned by the Chávez government, picketed in front of the Caracas hotel in which CEDICE was holding its 25th Anniversary Conference, waving signs denouncing the Cato Institute and accusing it of working with the Central Intelligence Agency and Washington military interests to create subversive dissent among Venezuelans. These protests were carried on state television.

The reaction of the Chávez regime to two gatherings of market-liberal intellectuals demonstrates how tense the situation has become in Venezuela. But it also demonstrates how necessary Cato's mission of promoting liberty is—and how fearful the ideas of liberty are for those who would wield excessive state power.

Cato University attendees gather in Caucagua, Venezuela, in May to discuss classical liberal ideas. The National Guard was sent to disrupt the event. State television stations and Internet sites spread propaganda charging Cato and local cosponsor CEDICE with setting up a training camp in subversive tactics to overthrow the government. The government's tactics ultimately failed and Cato's message of liberty remained loud and clear.

Continued from page 11

towns where either local, private coins or official coins could be used in exchange, private coins commanded a 100 percent premium over the other coins—which is to say you had to pay twice as much if you used the legal tender money! That's the market's verdict, the one that really counts.

Eventually private coinage was, of course, snuffed out. But in case you suppose that it was snuffed out because private coins were harming the public, it's easy to prove that that wasn't the case. When it decided to outlaw private tokens, the government still hadn't put its own coinage act together. Consequently people were literally left begging for cash of any sort. A government that was truly concerned about people having better money wouldn't have forced them to settle for having none at all!

To conclude: it's admittedly a long way from Great Britain in 1789 to the United States in 2009, but even the relatively distant past can harbor important clues to answering today's pressing public policy questions. One of those question is, must we forever remain at the mercy of the error-prone central banks? Must we forever suffer from the financial crises they cause again and again and again? Ancient dogma tells us that we have no choice. History, on the other hand, suggests that government's ancient monetary prerogative belongs in the same scrapheap into which most other medieval princely powers were tossed long ago. Perhaps central banks, which owe their existence to that prerogative, ought to be scrapped as well.

New website, conference, Capitol Hill briefings

Cato Scholars Take on Obama's Health Care Program

With the debate over health care reform heating up in Washington and around the country, the Cato Institute has taken the lead in providing principled free-market critiques and solutions. To bring its unique perspective to a wider audience, Cato launched a new website (healthcare.cato.org) to provide in-depth analysis of health care issues. The site is a perfect resource for everyone interested in becoming better informed on this crucial area of public policy.

Cato has also published two recent and important books on the health care. In *Healthty Competition: What's Holding Back Health Care and How to Free It*, Michael F. Cannon, director of health policy studies, and Michael Tanner, director of health and welfare studies, examine the best and worst ideas on health care reform from the left and the right—and provide their own, market-based solutions. And in *Crisis of Abundance: Rethinking How We Pay for Health Care*, adjunct scholar Arnold Kling argues against our current methods of financing health care, while advocating a return to individual responsibility.

The Cato Institute's new website (healthcare.cato.org) brings together the best analysis of health care policy from a market-liberal perspective. By making this information easily available in a single resource, Cato provides a powerful means to learn about this important area of public policy.

Director of health policy studies Michael F. Cannon speaks on Capitol Hill as part of Cato's Health Care University. Cannon taught members of Congress, their staff, and the media about the benefits of a free market health care system and the perils of increased government control.

Michael Cannon took the fight against big government in health care to Congress when, over the course of four days in April, he delivered four lectures on Capitol Hill as part of "Health Care University: Which Reforms Are Better—or Worse—than Doing Nothing?" There he laid out three "lines in the sand" regarding health care policy—no public plan, no mandates, and no price controls—as well as free-market solutions. Cannon continued to promote these principles in his debut as a columnist for *Kaiser Health News,* where, in May, he published a column, "Is Universal Coverage Comparatively Effective?" Cannon called on Congress to "start practicing evidence-based health policy." That same month, Cannon took Cato's message to the pages of *National Review*, as part of a special health care issue.

Cato has stood firm in its opposition to government-mandated health coverage, even as many others embrace Mitt Romney's "Massachusetts model." In June, Michael Tanner published "Massachusetts Miracle or Massachusetts Miserable: What the Failure of the 'Massachusetts Model' Tells Us about Health Care Reform." Tanner demonstrates the need to maintain free market principles in health care by exposing the awful outcome of what is now seen as the model for federal policy. He also addressed the potential federal plan directly with his latest Policy Analysis, "Obamacare to Come: Seven Bad Ideas for Health Care Reform."

But more than just showing what's wrong with our current health care system and the plans the Obama administration has for changing it, Cato analysts are offering a comprehensive set of solutions for America's health. Cato continues, for instance, to be a leading proponent of health savings accounts as an alternative or supplement to traditional health insurance.

On June 17, the Cato Institute took the opportunity to present both its critique of current and proposed interventionist health care and its vision for a better, free market future by hosting the Cato Institute Conference on Health Care Reform. This full day event featured a wide array of policy experts including U.S. Rep Paul Ryan (R-WI), Douglas Holtz-Eakin, former director of the Congressional Budget Office, and Susan Dentzer, editor-in-chief of *Health Affairs*, and Rick Scott, founder of Conservatives for Patients' Rights. Panels discussed health insurance mandates, health delivery-system reform, ideas for a new public plan, and free market alternatives for providing health care.

By providing a clear and coherent voice in opposition to the bad policies being proposed in Washington, as well as principled solutions, Cato is leading the way to better health.

TED GALEN CARPENTER, vice president for defense and foreign policy studies, and IAN VÁSQUEZ, director of the Center for Global Liberty and Prosperity, discuss the benefits of ending the international war on drugs at a Capitol Hill Briefing on May 15.

NEAL MCCLUSKEY, associate director of Cato's Center for Educational Freedom, argued at a Capitol Hill Briefing on April 7 that President Obama's goal of dramatically increasing the number of college graduates in the United States may not lead to exactly the results hoped for.

CHRISTOPHER A. PREBLE, director of foreign policy studies, is interviewed following a May 11 Capitol Hill Briefing on the dangers of U.S. military dominance. Preble argued that a reduction in military power will make America "richer, freer, and safer."

The Cato Institute continues to be a forum for scholars and policymakers from around the world actively involved in expanding freedom. On April 6 Chinese attorney KELIANG ZHU of the Rural Development Institute spoke at a policy forum about the status of land rights in China based on RDI's recent survey of Chinese farmers and about Beijing's tentative moves to strengthen those rights. On May 14 JANOS KOKA, former Hungarian minister of economics and former leader of Hungary's Free Democrats, discussed the causes of, and solutions to, the current economic crisis in Hungary. Koka, who is also the head of the special parliamentary committee on the Nabucco gas pipeline project, reported on the state of the pipeline.

APRIL 3: NATO at 60: A Hollow Alliance

APRIL 3: Drug Decriminalization in Portugal

APRIL 3: *Dead Aid: Why Aid Is Not Working and How There Is a Better Way for Africa*

APRIL 6: Securing Land Rights for Chinese Farmers: The Progress So Far

APRIL 7: What the Administration's College Proposals Would Do for America

APRIL 7: Seasteading: Homesteading the High Seas for Liberty

APRIL 14-17: Health Care University: Which Reforms Are Better—or Worse—than Doing Nothing?

APRIL 15: *The Beautiful Tree: A Personal Journey Into How the World's Poorest People Are Educating Themselves*

APRIL 16: Left Turn? South Africa after the Election

APRIL 17: Can Government Be Trusted with the Money Supply?

APRIL 20: Can the Pentagon Be Fixed?

APRIL 23: *The Power of Freedom: Uniting Human Rights and Development*

APRIL 24: Shadow Open Market Committee

APRIL 28: Restoring the Pro-Trade Consensus

APRIL 30: Cato Institute Policy Perspectives 2009, New York

MAY 1: The Dangers of U.S. Military Dominance

MAY 11: How Overreaction and Misdirection Play into the Strategy of Terrorism

MAY 15: Is It Time to End the International War on Drugs?

MAY 18: *The Welfare State We're In*

MAY 19: *Money, Markets, and Sovereignty*

Audio and video for all Cato events dating back to 1999, and many events before that, can be found on the Cato Institute website at www.cato.org/events. You can also find write-ups of Cato events in Ed Crane's bimonthly memo for Cato Sponsors.

Cato Calendar

CONSTITUTION DAY

Washington • Cato Institute
September 17, 2009

CATO CLUB 200 RETREAT

Santa Barbara, California
Four Seasons • October 8-11, 2009

RESTORING GLOBAL FINANCIAL STABILITY

27th Annual Monetary Conference
Washington • Cato Institute
November 19, 2009

Speakers include William Poole, George Selgin, Judy Shelton, Lawrence H. White, and Kevin Murphy.

MILTON FRIEDMAN PRIZE PRESENTATION DINNER

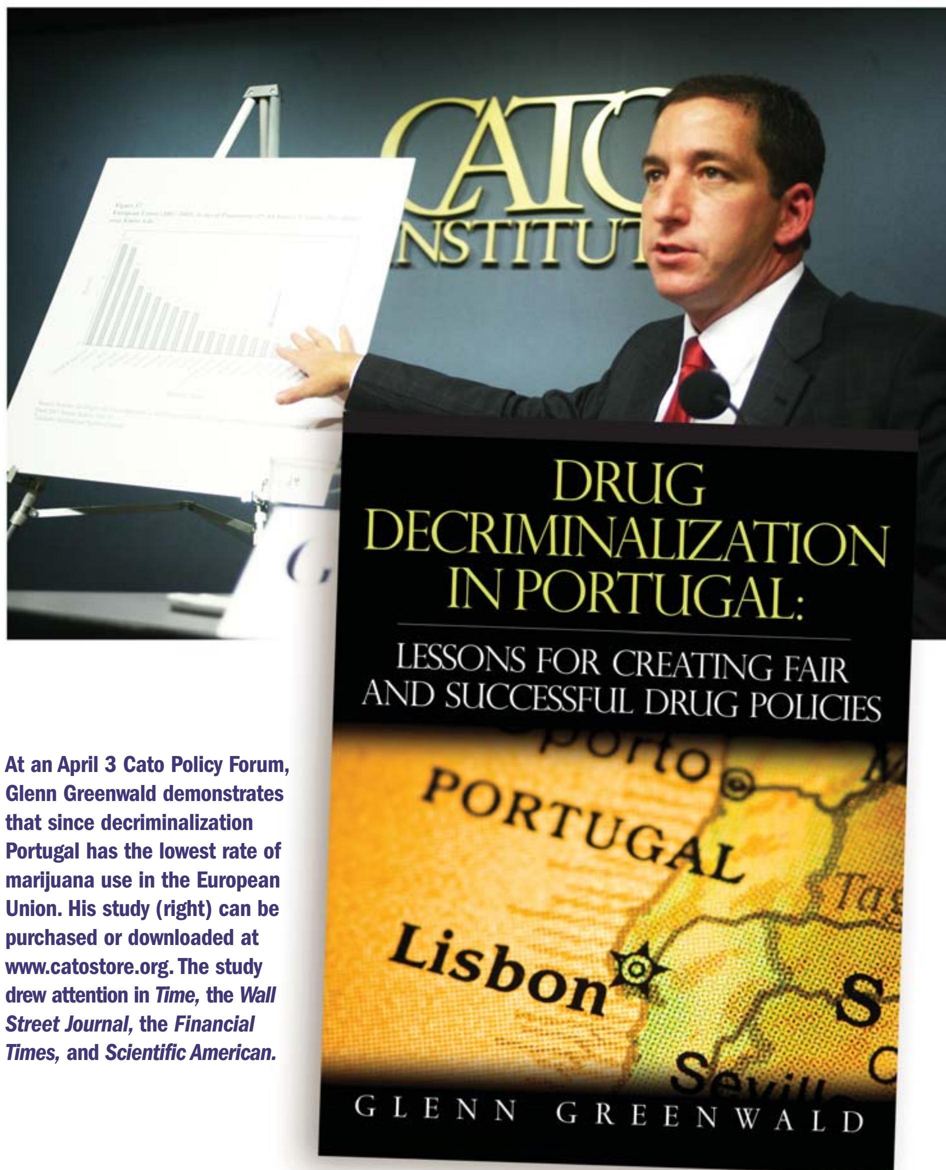
Washington • Hilton Washington
May 13, 2010

Study one of first to look at little-known success story

Report: Drug Decriminalization Works in Portugal

In 2001, Portugal took the dramatic step of decriminalizing all drugs, including heroin and cocaine. Although it did not receive a lot of attention at the time, Tim Lynch, who directs Cato's Project on Criminal Justice, decided it would be a good idea to commission a study on the Portuguese policy experiment after it had been given a fair chance to work over several years. In 2007, when Lynch met best-selling author and lawyer Glenn Greenwald and discovered that Greenwald was fluent in Portuguese, Lynch's search for the right author was finally over. Greenwald readily agreed to the idea of traveling to Portugal to interview key lawmakers and health officials. Upon his return, Greenwald began to prepare the most exhaustive study on the Portuguese experiment.

On April 2, Cato released *Drug Decriminalization in Portugal: Lessons for Creating Fair and Successful Drug Policies*. The study notes that while other states in the European Union have developed various forms of de facto decriminalization—whereby substances perceived to be less serious (such as cannabis) rarely lead to criminal prosecution—Portugal remains the only EU member state with a law explicitly declaring drugs to be "decriminalized." (Portugal has stopped short of "legalization" because drug dealing remains a criminal offense.) The shift in policy was controversial. Conservatives in Portugal argued that the move to decriminalize would only worsen that country's drug problems.



At an April 3 Cato Policy Forum, Glenn Greenwald demonstrates that since decriminalization Portugal has the lowest rate of marijuana use in the European Union. His study (right) can be purchased or downloaded at www.catostore.org. The study drew attention in *Time*, the *Wall Street Journal*, the *Financial Times*, and *Scientific American*.

With more than seven years of experience under the decriminalization regime, Greenwald reports that the policy has been quite successful. One of the key findings of the study is that none of the nightmare scenarios predicted by decriminalization opponents—from rampant increases in drug usage among the young to the transformation of Lisbon into a haven for "drug tourists"—has occurred. As a result, Greenwald reports that the political climate in Portugal has changed: there is no longer any serious debate about whether drugs should once again be criminalized.

Drug policy experts have seven years of relevant empirical information to examine. Those data indicate that decriminalization has had no adverse effect on drug usage rates in Portugal, which, in numerous categories, are now among the lowest in the EU, particularly when compared with states with stringent criminalization regimes. Although post-decriminalization usage rates have remained roughly the same or even decreased slightly when compared with other EU states, drug-related pathologies—such as sexually transmitted diseases and deaths due to drug usage—have decreased dramatically. Greenwald says drug policy experts in Portugal attribute those positive trends to the enhanced ability of the government to offer treatment programs to its citizens—enhancements made possible, for numerous reasons, by decriminalization.

Greenwald's study has garnered plenty of media attention since it was released in April. *Time Magazine*, the *Wall Street Journal*, the *Financial Times*, and the *Scientific American* are among the numerous publications that have cited the findings of this Cato report.

Private schools in the midst of poverty

Bootstrapping Education

Private schooling is often thought of as being exclusively for the privileged. But that is not the case in the developing world. A thriving, virtually unknown, private education sector has emerged there, allowing many of the world's poorest people to rescue their children from failed government schools for as little as $10 a year. In *The Beautiful Tree: A Personal Journey into How the World's Poorest People Are Educating Themselves*, James Tooley documents this phenomenon, explaining how hundreds of millions of people, from the slums of India to the shanty towns of Africa, are reaching into their almost-empty pockets to give their children a fighting chance.

Conducting the research wasn't easy. In Zimbabwe, Tooley reports he was interrogated in a basement by Robert Mugabe's goons. Meanwhile, in virtually every location Tooley visited he was told by government officials that no private schools for the poor existed at all. In Gansu, China, senior officials denied Tooley's request to research private for-profit schools because it was a "logical impossibility"—universal public education had been achieved there and private schools were against government policy. But whenever Tooley struck out on his own to visit the slums and villages, a different story emerged. In the slums of Hyderabad, India, Tooley found that 53 percent of the 918 schools there were private. Of the private schools, the majority of those were not even recognized by government statistics. In Gansu, Tooley was ultimately able to bypass the officials and found 586 private schools for the poor there.

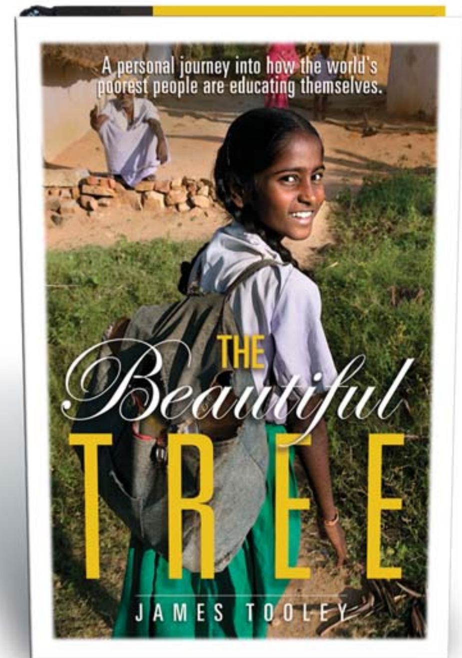
While such schools are typically less equipped than their public counterparts, with teachers lacking comparable credentials, they have one important advantage: they serve their customers. In Gansu, the private schools were not necessarily better than their public peers, but they were much closer to the farms and villages where people lived. And while the far-away Chinese public schools were "free," they used more expensive books than did the private schools, making them more expensive for the parents.

Meanwhile, teacher absenteeism is rampant in government-run schools in the developing world. When Tooley and his research team called unannounced on the classrooms in Hyderabad, 98 percent of the teachers were actually teaching in the private recognized schools, compared with 91 percent in the unrecognized schools and 75 percent in the government schools. In Ga, Ghana, only 57 percent of teachers were actually teaching in the government schools when randomly called.

Even if underpublicized, private schooling is definitely a large and significant phenomenon in the developing world. But how effective are the private schools compared to their public peers? In order to test that question, Tooley set about on a massive research project, documenting the IQ and test scores in math and English of more than 3,000 students in India, Kenya, Ghana, and Nigeria. What Tooley discovered was remarkable. In Hyderabad, students attending recognized and unrecognized private schools outperformed their peers in government schools by a full standard deviation in both English and math (after accounting for differences in their observable characteristics). In Ghana, the private-school advantage was between 0.2 and 0.3 standard deviations in both subjects. And in Kenya, he found that private schools, though serving a generally less advantaged population, were 0.1 standard deviations above their public counterparts in English and 0.2 deviations above public schools in math. All of these results were highly statistically significant. In a word, private schools were doing better than public schools for a fraction of the cost.

If the free education marketplace can more effectively serve families in some of the most disadvantaged corners of the globe, imagine what it could do in far wealthier nations such as our own.

Visit www.catostore.org or dial 800-767-1241 to get your copy of *The Beautiful Tree* today; $19.95 hardcover.



"Surprising...engaging...a moving account of how poor parents struggle against great odds to provide a rich educational experience to their children."
—***PUBLISHERS WEEKLY***

"This is a great book—iconoclastic, refreshing, well-written, and careful. Tooley's detective work reveals a major undiscovered planet: private schools for the poor."
—**WILLIAM EASTERLY,**
New York University; Author, *White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good*

Unwieldy, Inequitable, Costly, and Disruptive

Financial institution bailout policy in the United States is implemented through three agencies: the Federal Deposit Insurance Corporation, the Federal Reserve, and the Treasury Department. The need for orderly financial dealings, particularly in times of crisis, would dictate a consistent approach by these agencies based on cumulative experience, ensuring that officials devote public resources only where there is a well-defined, transparent, and verifiable policy justification for a bailout. Yet the bailouts over the past year do not reflect a well-defined, transparent, and verifiable policy justification. Even in the cases where a standard has been articulated, the agencies have not demonstrated that they can successfully implement that standard in practice. Vern McKinley, formerly of the FDIC and currently a central bank consultant, and Gary Gegenheimer, a senior legal adviser with BearingPoint, argue in "**Bright Lines and Bailouts: To Bail or Not to Bail, That Is the Question**" (Policy Analysis no. 637) that financial-institution bailout policy has been unwieldy, inequitable, extremely costly, disruptive, and lacking in transparency and oversight. The policy response of bailouts and maintenance of the status quo has been precisely the wrong response, as it has led to retaining many of the mega-financial institutions that pose systemic risk, thus planting the seeds for future crises. The ultimate answer is to place troubled institutions into receivership or the relevant form of bankruptcy—including many of the institutions that have already been bailed out.

Making Free Trade Popular Again

For more than 40 years the United States has benefited from a level of pro-trade sentiment, among both the public and its government. Recently, however, this sentiment is in decline. Daniel Ikenson, associate director of the Center for Trade Policy Studies at the Cato Institute, and Scott Lincicome, an international trade attorney, debunk several myths of the anti-trade movement in "**Audaciously Hopeful: How President Obama Can Help Restore the Pro-Trade Consensus**" (Trade Policy Analysis no. 39). America's manufacturing sector is not fleeing across international borders. Prior to the current recession, U.S. manufacturing was thriving and recorded record output in 2007. The current obsession over trade deficits is unwarranted, the authors argue. The deficit is not a function of trade policy but rather of varying patterns of consumption and saving. The focus on trade agreement violations is also troubling, as these agreements have only a small impact on the U.S. trade account and economy.

Dangerous Pakistan

Along the border between Pakistan and Afghanistan, U.S. and NATO troops and local tribes are threatened by a spreading Islamic insurgency. Maintaining security in the region is essential. Cato foreign policy analyst Malou Innocent, who recently spent several weeks in Pakistan, explains how it can be accomplished in "**Pakistan and the**

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Future of U.S. Policy" (Policy Analysis no. 636). Learning from experiences in Iraq—while recognizing the uniqueness of Afghanistan—the United States should support counterinsurgency actions through a small number of Special Forces personnel. To improve the ability of the Pakistani forces to conduct this battle themselves, training of Pakistani troops at American military institutions must be made a greater priority. Yet any aid to Pakistan should come with strong oversight, something absent from the $20 billion already spent on aid in the region. Support must be conducted without endorsing particular leaders, however, as the current methods injure their credibility while fostering resentment of U.S. involvement in Pakistani politics.

Trade Not Aid for Africa

Foreign aid has done Africa more harm than good, encouraging waste and corruption while failing to stimulate economic growth. Major industrial countries, meeting in Gleneagles, Scotland, in 2005, agreed to give the continent more of the same. In **"The False Promise of Gleneagles: Misguided Priorities at the Heart of the New Push for African Development"** (Development Policy Analysis no. 9), Marian L. Tupy, policy analyst at the Cato Institute's Center for Global Liberty and Prosperity, argues that trade liberalization has the greatest potential to bring Africa out of poverty. History shows that sustained economic growth is necessary for moving a country toward wealth—and that free trade is the best path to economic growth. Removing restrictions on African exports and ending Western farm subsides that hurt the market for Africans crops should be a priority.

Drug Decriminalization in Portugal

Faced with rampant drug use, few American policymakers would seek solutions in more liberal drug laws. But that's what Portugal did in 2001—and the European country has since quietly enjoyed the benefits of drug decriminalization. In **"Drug Decriminalization in Portugal: Lessons for Creating Fair and Successful Drug Policies,"** Glenn Greenwald, a constitutional lawyer and contributing writer at Salon, explains why Portugal should be a model for United States drug policy. After no success with traditional drug war methods, a nonpolitical commission in Portugal decided to decriminalize all drugs, making possession a civil, rather than criminal, offense. Opponents believed that once decriminalized, drug use rates would explode. Greenwald's study shows, however, that, seven years after decriminalization, those grave predictions were false. First-time prevalence rates for every drug have decreased and high school drug use has fallen significantly.

Exploding Federal Subsidy Programs

The budget has doubled in eight years to $3.9 trillion. In 2008 there were 1,804 different subsidy programs in the federal budget—up from 1,019 in 1970—and the recent stimulus bill added even more. Chris Edwards, director of tax policy studies at the Cato Institute, discusses the "largest federal gold rush since the 1960s" in **"Number of Federal Subsidy Programs Tops 1,800"** (Tax and Budget Bulletin no. 56). This drastic increase in federal programs violates ideals of federalism. Edwards suggests that people use new internet tools, such as www.usaspending.gov, to research subsidy spending and, armed with this knowledge, petition Congress about the abuse of tax dollars.

Sneaking the Fairness Doctrine Back In

In **"Broadcast Localism and the Lessons of the Fairness Doctrine"** (Policy Analysis no. 639), John Samples, director of the Center for Representative Government at the Cato Institute, looks to history to provide a warning against embracing government intervention in First Amendment territory. From 1949 to 1987, the Fairness Doctrine imposed politicians' ideas of fairness upon broadcasters—along with considerable compliance costs. Four decades of government regulation of the press resulted not only in a chilling effect on speech but, in many cases, the use of legislation to silence political dissent. New proposals justified in the name of "serving local communities," including content requirements and advisory boards to oversee managing stations, would risk the same chilling effect on speech that the Fairness Doctrine had.

Obamacare's Seven Deadly Sins

Although Obama's health care plan presents a wealth of problems, Michael Tanner, senior fellow at the Cato Institute, boils them down to a handful of issues in **"Obamacare to Come: Seven Bad Ideas for Health Care Reform"** (Policy Analysis no. 638). First, labor costs would rise as employers would have to provide insurance to their workers. Second, individual choice in insurance would be replaced by a pool of providers deemed acceptable by government. Third, the government itself would compete against private providers. Fourth, comparative-effectiveness guidelines would limit the ability of providers to meet patient needs. It would force private insurers to accept all applicants and would prohibit them from employing risk-based premiums. Sixth, the plan would expand Medicare and Medicaid, as well as subsidize private insurance purchases. Finally, an expensive system of national electronic medical records would be mandated. So many bad ideas spell trouble for America's future health.

Zimbabwe's Harmful Farm Policy

Zimbabwean president Robert Mugabe's costly and unjust land reforms are discussed in "The Cost of Zimbabwe's Continuing Farm Invasions"(Economic Development Bulletin no. 12) by Eddie Cross, an economist and opposition member of Parliament. Claiming to redress historical injustices and racial imbalances in land ownership, Zimbabwe enacted the Fast Track Land Reform. Farmers who wish to sell their land must first offer it to the government at a market price. In theory, farmers have full rights to their land. But in practice, Zimbabwe has been taking farms without paying market price. The effects are staggering. Zimbabwe has lost 69 percent of its agricultural output and 70 percent of the value of its crops.

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"To Be Governed..."

NO MEDIA BIAS HERE

The G-20 economic summit reached a final agreement to restore the world's economy Thursday only after President Barack Obama personally intervened.

—**McClatchy Newspapers,** April 2, 2009

After getting blasted last week for presenting a budget plan light on details, House Republicans yesterday unveiled a more complete proposal that would cut taxes for businesses and the wealthy, freeze most government spending for five years, halt spending approved in the economic stimulus package and slash federal health programs for the poor and elderly.

—***Washington Post,*** April 2, 2009

YET SOMEHOW THEY GET AN "F" EVERY YEAR FROM THE NATIONAL TAXPAYERS UNION

The respective heads of the House and Senate Budget Committees, John Spratt, Jr., of South Carolina, and Kent Conrad, of North Dakota, have spent years trying to control the deficit . . .

Kent Conrad, the chairman of the Senate Budget Committee, has made eradicating the federal budget deficit his life's work.

—***New Yorker,*** May 4, 2009

A STAUNCH DEFENDER OF ALL OF HIS MARRIAGES

D.C. Councilman Marion Barry told church leaders and other opponents of gay marriage Tuesday that he opposed the city council's decision to recognize same-sex marriages performed outside the District.

Calling himself "a politician who is moral," Barry said he would have voted against the measure if he had been present at the April 6 session.

—***Washington Examiner,*** April 28, 2009

1-800-[GET OTHER PEOPLE'S MONEY]

Dear Nonprofit Professional,

Billions of dollars from the Obama stimulus plan are becoming available daily for funding thousands of new state, local and nonprofit programs!

And while it's extremely time consuming and difficult to keep up with the ever-changing opportunities and the complex requirements to apply for them, we can help make that task easier than you'd imagine . . .

—**Email received** April 29, 2009

INSIDE EACH BAILOUT, ANOTHER BAILOUT

Matryoshki, the wooden nesting dolls that are synonymous with Russian folk art—those gourd-shaped figures that can be pulled apart to reveal ever-smaller dolls—are in trouble. . . .

With the country enduring its worst economic downturn in a decade, matryoshka manufacturers are pleading with the government for aid, and warning that their survival could depend on it because sales have already fallen by at least a third.

The Kremlin has agreed to add the matryoshka to its bailout budget, pledging to buy nearly $30 million worth of the dolls and other souvenirs for officials to give away as gifts.

—***Washington Post,*** May 31, 2009

BAILOUT NATION

- More Homeowners Getting Aid, but Demand Keeps Rising
- AIG Could Repay U.S. in 3 to 5 Years, Chief Tells Congress
- Treasury Clarifying Rules for Bailed-Out Firms
- Small Auto Suppliers Seek Help in Wake of Giants' Woes

—**Headlines in the *Washington Post,*** May 14, 2009

OBAMA'S REPUBLICAN LAYS IT ON THE LINE

Question: Some in the highway supporters and motorists groups have been concerned by your livability initiative. Is this an effort to make driving more tortuous and to coerce people out of their cars?

LaHood: It is a way to coerce people out of their cars, yeah. . . .

Question: Some conservative groups are wary of the livable communities program, saying it's an example of government intrusion into people's lives. How do you respond?

LaHood: About everything we do around here is government intrusion in people's lives.

—**Transportation Secretary Ray LaHood at the National Press Club,** May 21, 2009