



The Case for Open Global Capital Markets

by **Robert Krol**

Executive Summary

Recent financial problems in emerging economies have led to calls for a new international financial architecture. Proposals include restricting short-term capital flows and extending the International Monetary Fund's role to that of an international lender of last resort. Both "reforms" would be mistakes.

International capital flows should not be restricted; they benefit entrepreneurs and savers alike, with lower borrowing costs and greater returns. The international flow of capital improves risk management, allows consumption smoothing, improves financial-sector efficiency, and leads to greater overall market discipline. Furthermore, capital flows have a stabilizing effect on financial markets. Restricting international investment denies a country those benefits; the result is slower growth and reduced standards of living.

Expanding the IMF is a bad idea. It would increase the power of an institution that has promoted ineffective macroeconomic adjustment programs. The IMF's lending programs do not provide strong

incentives for fundamental market reforms. Instead of helping to create sustainable economic growth, IMF interventions promote a debilitating dependence on further IMF loans.

Repeated IMF bailouts encourage excessive risk taking by both lenders and borrowers. The result is more frequent and severe financial crises. Expanding the role of the IMF will just lead to more of the same. A better strategy would be to reduce the power of the IMF, ending its role as the global guarantor for international investors.

Without IMF intervention, global investors will increase their scrutiny of the economic policies of emerging market economies. Countries that want access to world capital will face strong incentives to adopt market reforms. As a result, global capital will be used more prudently and efficiently. There will be fewer and less-severe financial problems. An open global capital market can thus serve as an important engine for worldwide economic growth in the 21st century.

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Introduction

Recent financial problems in Latin America, Asia, and Russia have led to calls for a new international financial architecture. Elected officials and even some economists have come to question the wisdom of open global capital markets. The two most talked about reforms are placing restrictions on short-term capital flows and expanding the International Monetary Fund's function to that of an international lender of last resort. Both reforms would be a mistake.

International capital flows increase investment by lowering the cost of capital, improve risk management, and raise the efficiency of resource usage.

Capital controls, even those placed only on short-term investment, harm economic performance. Those controls reduce domestic and direct foreign investment, slowing economic growth. Contrary to popular opinion, removing controls has a stabilizing effect on financial markets.

Expanding the IMF would give more resources and power to a bureaucracy that has failed to provide emerging economies with the proper incentives for fundamental economic reform. Ineffective IMF adjustment programs delay necessary economic reforms. Instead, there is only a record of country dependence on IMF loans.

Repeated IMF bailouts increase risk taking, which results in larger and more frequent episodes of financial distress. With the IMF as global guarantor, investors have taken on risky, imprudent projects. It is time to end the role of the IMF as the global international financial manager.

If economic growth is our objective, private global capital markets must be allowed to work. Without the IMF standing by as global guarantor, private investors will lend in a more prudent, efficient manner. The result will be fewer, and less severe, financial crises.

Without IMF intervention, countries in search of private investors will have strong incentives to adopt the kinds of market reforms

needed for sustained long-term economic growth. Such growth benefits investors and noninvestors alike. The result will be higher living standards worldwide.

This paper begins with a discussion of the benefits of open global capital markets. Then the effects of government and IMF interventions on financial markets are discussed. The focus is on capital controls, financial bailouts, and IMF-led adjustment programs. The paper closes with an investigation of the issues surrounding reforming the IMF.

The Benefits of Global Capital Flows

Access to the global capital market provides an economy with a number of significant benefits. These include lower borrowing costs for entrepreneurs and greater returns to savers. Additional benefits include improved risk management (through international investment diversification), the ability to smooth consumption when faced with adverse economic shocks, and greater financial-sector efficiency as a result of increased competition from foreign financial institutions. Open capital markets also subject both business and government to greater market discipline.¹

To understand the impact of the free flow of capital on entrepreneurs and individuals who save, imagine what happens in an economy completely cut off from global markets. In this economy, the supply of funds available to finance business investment is limited to domestic sources. If total saving in this economy is low, then borrowing costs will be high. The high cost of borrowing will deter all but the most lucrative business projects; other potentially productive projects will go without funding. Without substantial capital formation, there is little economic growth.

Now imagine a second economy that is also cut off from global markets. However, this time total saving is high, resulting in low borrowing costs. Low borrowing costs increase the number of business projects that are financed. Although investment and capital formation are

high, the abundance of capital means that some funds go to less-productive projects.

The problem with closed capital markets is that the high-saving country is financing some projects that pay a return below what could be earned on projects that remain without funding in the low-saving country. The overall level of well-being in both countries would improve if those countries were to open their capital markets to one another.

With open markets, capital will flow from the high-saving economy to the low-saving economy. More high-return projects will be financed in the low-saving country, promoting economic growth and a higher standard of living. Although investment in the high-saving country declines as funds are invested abroad, the higher return on international loans results in greater consumption over time.²

The low-saving case just described characterizes many of today's emerging economies. How large an impact do we find on investment when countries open their capital markets to foreign investors? One analysis of 11 emerging economies found that average growth of private investment increased by 22 percent above the sample average in the three years following the opening of emerging countries' stock markets to international investors.³

Stock market liberalization in emerging countries results in greater capital inflows, greater stock market liquidity, and a falling cost of capital. Another study estimates that the cost of capital in emerging markets declines between 5 and 75 basis points following capital market liberalization.⁴ As the cost of equity capital falls, higher stock market prices allow private firms to expand, increasing investment.

Evidence from 41 industrialized and emerging economies during the 1970s and 1980s confirms that countries that allow international investment have higher levels of economic growth, productivity, and capital formation.⁵ Taking reasonable steps toward eliminating restrictions on international investment produced a 6 percent increase in real per capita gross domestic product over a 10-year period.⁶

Open capital markets allow investors and banks to diversify their portfolios internationally,

lowering total portfolio risk. Improved risk management not only results in greater investment but also lowers the frequency of financial crises.

To understand the benefits of diversification, consider an individual investor. Few investors hold only one stock; indeed, the typical portfolio contains stocks, bonds, and real estate. Investors understand that diversification lessens total portfolio risk. The reduction in risk occurs because the returns on assets are not perfectly correlated. For example, when a few companies have bad years and pay a low return, other firms have good years and offer a high return. As a result, a diversified portfolio's overall return is more stable; total portfolio risk is reduced. The risk in a portfolio of 20 U.S. stocks is 70 percent less than that of a portfolio that contains a single stock.⁷

Further portfolio risk reduction can be gained through international diversification. Because business cycles are not perfectly correlated across countries, stock and bond market returns across countries do not move in perfect unison. The negative impact of a recession in one country is offset by the impact of a boom in another. An individual investor can lower total risk by purchasing foreign as well as domestic stocks and bonds. A portfolio of 20 stocks selected from major markets around the world lowers risk by an additional 15 percent over a portfolio composed solely of U.S. stocks.⁸ This risk reduction improves the welfare of the average investor.⁹

In economies that are not well integrated into the world economy, individuals face a greater risk that poor economic performance will lower their standard of living. Crop failures or oil price shocks can cause an economy's output to decline. A recession causes income and consumption to fall.

Individuals in countries with underdeveloped and highly regulated domestic capital markets find it difficult to borrow and smooth consumption during bad times. Capital market integration can help cushion the negative impact of lower income on consumption. Individuals can increase borrowing from abroad during a recession. Countries that are linked to global capital markets effectively share the risk of downturns by borrowing from abroad.¹⁰

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The international flow of capital can improve the efficiency of a country's financial system. In the past, many emerging economies (and some industrial countries as well) chose to restrict foreign participation in their domestic stock markets and banking sectors. Interest rate limits created an excess demand for funds, allowing the government to step in and dictate the use of funds. The result was a highly inefficient financial system.

Opening these markets to foreign investors provides a number of economic advantages. Increased competition improves financial system efficiency. Faced with competition, domestic banks will adopt new banking technologies and improve banking skills, enhancing the quality and quantity of banking services. As a result, a country's savings end up being used more effectively, increasing productivity and economic growth.¹¹

It has been shown that the entry of foreign banks has a significant impact on the profitability and cost of a country's banking system. Banks operating in countries that face little competition tend to earn higher profits and operate less efficiently.¹² As the number of foreign banks operating in a country's domestic market increases, both profits and operating expenses decline, resulting in a more efficient domestic banking system. A competitive and efficient banking system cannot afford to favor inefficient projects just because borrowers are politically connected. Funds are far more likely to be directed to the most viable projects. The impact of more efficient use of capital can be seen in increased productivity and economic growth.¹³

Stock market liquidity is important to the market process. The easier it is to trade stocks, the better markets are at providing long-term financing to businesses. There is evidence that liquid stock markets have a positive impact on economic growth. Open capital markets increase stock market liquidity, providing an additional channel through which the free flow of capital promotes economic growth.¹⁴

Open capital markets force market discipline on both corporations and government policymakers. In competitive stock markets, prices reflect the markets' assessment of a firm's

performance outlook. This allows investors to evaluate how well a business is run. Poorly run firms, with low stock prices, become takeover targets. Profit-seeking outsiders purchase a controlling interest in these firms, replace or reform management, and push to improve efficiency and profitability. Smoothly running stock markets allow this "market for corporate control" to operate more effectively. Knowing their jobs are on the line, managers have a strong incentive to make decisions that maximize the firm's value, leading to better investments over time.

Open capital markets also impose discipline on government policymakers. Governments that initiate inflationary or anti-growth policies will quickly draw an adverse reaction from investors. For instance, when budget deficits are financed by rapid growth of the money supply, fears of inflation will rise. International investors "cast their ballots" against this policy by selling the country's currency. The result is a weaker currency or a loss of international reserves (which increases the chances that the currency will be devalued in the future). As foreign creditors become less willing to lend, interest rates paid by domestic borrowers rise. The higher interest rate and weaker currency make imports and foreign loan payments more costly in terms of the domestic currency. Political pressure from affected borrowers causes the government to limit deficits and the associated inflationary finance.

The potential of a negative vote by investors in response to poor government policy acts as a constraint on actions that worsen economic performance. This constraint not only improves the investor's returns; it helps to maintain pro-growth policies that benefit non-investors as well.

In sum, global capital markets lower the cost of capital, spur investment, and encourage economic growth. Greater financial-sector competition results in better risk management and better use of capital. Open capital markets provide incentives for better government economic policymaking. Taken together, these developments positively affect a country's overall standard of living.

The Weak Case for Capital Controls

Despite strong evidence on the benefits derived from open global capital markets, governments still turn to capital controls. Prime Minister Mahathir Mohamed of Malaysia, seeking to cover for his own economic mismanagement, blamed foreign speculators for the financial crisis in his country.¹⁵ In September 1998, Malaysia imposed capital controls.

Imposing capital controls during times of economic trouble may be politically expedient, but it ultimately harms the economy. Proponents argue that limits on primarily short-term foreign investment will stabilize domestic financial markets. Proponents of controls seem oblivious to the consequences for capital costs, domestic investment, and long-term foreign direct investment.

Controls on short-term capital flows have been justified on the basis of the alleged herding behavior of investors. Investors are said to “herd” when they copy the behavior of other investors.¹⁶ Herding has been blamed for increasing asset price variability in financial markets, especially in emerging economies. This behavior is blamed for destabilizing financial markets around the globe.

Critics of free global capital flows often view the comovement of asset returns across countries as evidence that contagion is significant. There are a number of problems with this argument.¹⁷ First, if a country’s financial market is fully integrated into world markets, there will be a tendency for stock returns to move together in response to common global factors even if there is no contagion.

For instance, when the world economic outlook for the automobile industry worsens, the stock price of automobile firms will decline worldwide. This adjustment reflects the rational downward revaluation of auto industry equity. It represents an efficient shift of capital away from the auto industry and toward other, less troubled industries.

Second, the contagion hypothesis is supported by the observed increase in the correlation

between asset returns in different countries during periods of relatively greater financial market volatility. However, recent statistical studies question the interpretation of this evidence.¹⁸ Researchers have used methods that show a rise in correlation during periods of stock market volatility when, in fact, the true relationship between market returns has not changed. Once the error is corrected, the apparent significant increase in interdependence disappears.

A third argument is that poorly informed investors panic at the first sign of a market downturn; those investors’ decisions lead to asset price movements that are greater than warranted by economic fundamentals. Without providing evidence, capital control enthusiasts believe foreign investors are more likely to behave in this manner.

The flaw in this argument is that it fails to recognize that asset price movements in excess of those warranted by economic fundamentals create profit opportunities for informed investors. Those investors will quickly take advantage of any opportunity for profit, moving the asset price to a level more consistent with fundamentals and thus stabilizing the market. The only reason this process would not work would be if funds were unavailable. The appropriate public policy response, in this case, is not to limit foreign investment but to encourage it.

Finally, the empirical case for herding behavior is not strong.¹⁹ While there are studies that find cases of herding behavior, the general conclusion is that herding by institutional investors is quantitatively small. Herding behavior should lead to asset price movements during periods of high trading volume, but that has not been observed. If herding behavior is significant, then financial market volatility should increase following liberalization. One analysis of 20 emerging economies found that, in every case, stock market volatility declined after liberalization. This is the exact opposite of what opponents of open capital markets would predict.²⁰

Current calls for capital controls stress the need to limit short-term portfolio flows but not foreign direct investment. This position is based on the notion that short-term portfolio investment is less stable. Once again, the evidence does not support conventional wisdom.

Imposing capital controls during times of economic trouble may be politically expedient, but it ultimately harms the economy.

Any controls on short-term portfolio investment that raise capital costs reduce the economic viability of direct investment projects. Direct foreign investment will be deterred.

Portfolio investment is no less stable than direct investment or official lending.²¹ In terms of volatility, there appears to be no basis for discriminating against portfolio investment.

Restricting short-term portfolio investment is not a free lunch. It will reduce both domestic investment and direct foreign investment, the exact type of investment capital-control enthusiasts want to encourage.²² Capital inflows—of any kind—lower the cost of capital. Limits on short-term foreign investment will raise the cost of capital. Fewer businesses will undertake new projects.

When foreign businesses consider building manufacturing plants abroad, the cost of capital used in the investment decision is the cost in the host country. Any controls on short-term portfolio investment that raise capital costs reduce the economic viability of direct investment projects. Direct foreign investment will be deterred.

Governments must be careful about the signals they give by restricting short-term capital flows. Restrictions on short-term flows raise fears that, if the economy worsens, additional constraints will be imposed. The ability to repatriate profits associated with direct investment becomes a legitimate concern.

Finally, given the criticism levied against foreign investors, it is informative to examine their role during the 1997 financial crisis in Asia. International hedge funds have been blamed for the Asian currency and stock market collapse of 1997. However, examination of the 10 largest funds during 1997 finds no connection between their currency exposure and the resulting currency collapse.²³

There is no evidence that the major speculative funds, big as they are, can move currencies. In fact, at the peak of the currency crisis in Malaysia, the 10 major hedge funds were buying ringgits. This type of behavior, buying against the market, is called negative feedback trading. If anything, it appears that trading by international hedge funds in 1997 increased market liquidity and had a stabilizing effect on the market.²⁴

Similarly, it cannot be shown that disproportionate selling by foreign investors led the market down during the Korean crisis period. There is no evidence that during 1997 foreign

investors simultaneously sold stock. The selling of stocks by foreign investors generally did not result in falling stock prices. Not surprisingly, it was Korean investors who had the biggest impact on their own stock market performance during the crisis period.²⁵

The case for capital controls rests on the assumptions that investors act as a herd and contagion is widespread in financial markets. The evidence does not support those assumptions. The imposition of capital controls increases the cost of capital, lowering both domestic and direct foreign investment. Capital controls reduce economic growth and fail to stabilize financial markets.

Do Government Guarantees Increase Private Risk Taking?

A central issue in any attempt to improve the international financial system centers on whether government loans and guarantees create a moral hazard problem.²⁶ Put differently, do IMF bailouts and government (implicit or explicit) loan guarantees lead to excessive risk taking by both borrowers and lenders, increasing the severity of financial crises?²⁷

The 1995 Mexican rescue has served as a lightning rod for this debate. Immediately following the crash of the peso in December 1994, the U.S. Treasury, the IMF, and the Federal Reserve put together a loan deal for Mexico worth \$41 billion.²⁸ What makes this bailout stand out was the record size of the package and the fact that it came after a massive devaluation of the peso. Effectively, these loans enabled the Mexican government to ensure repayment on dollar-guaranteed *tesobonos* bonds.²⁹

The IMF and the Clinton administration called the rescue a success because the Mexican government repaid the U.S. loans.³⁰ However, the fact that the devaluation resulted in a dramatic loss of income for the average Mexican citizen calls into question that assessment of the program.³¹ The economic recovery has been confined to sectors of the Mexican economy engaged in international trade; roughly half of

the remaining economy has not recovered. In addition, high levels of nonperforming loans continue to plague many Mexican banks.³²

Armed with this evidence, critics argue that the bailout protected primarily foreign investors, who would have taken large losses on Mexican loans without the bailout. The Mexican bailout set the stage for the Asian crisis that followed two years later. Banks felt secure in lending to the emerging markets of Asia.

Not only did the IMF bail out foreign banks but, following the 1994-95 Mexican crisis, the IMF asked for a significant increase in funding. The signal to financial institutions was that funds would continue to be available to protect banks from the risk associated with emerging-market lending. Financial institutions predictably responded by increasing their lending in emerging markets. Before the Mexican crisis, portfolio investment in emerging markets had been rising (from about \$60 billion to \$194 billion between 1990 and 1996). Following the Mexican crisis, portfolio investment declined; bank lending rose significantly.

There is limited evidence on the extent to which moral hazard is increased by official interventions in global financial markets. There is, however, evidence from domestic bailouts and guarantees suggesting that the moral hazard effect of government intervention is significant.³³

Research shows that deposit insurance reduces monitoring by depositors, resulting in greater risk taking on the part of bank managers. A study of 61 countries during the 1980s and 1990s found that countries with deposit insurance had a greater chance of having a banking crisis.³⁴ Researchers found that making the insurance explicit or expanding the coverage, or both, increases the chances of a banking crisis. Charging risk-adjusted insurance premiums and forcing banks to purchase insurance reduce the chances that a banking crisis will occur.

A case study of Argentina, Canada, and Mexico provides additional evidence.³⁵ Deposit insurance coverage varies considerably in those three countries. Mexico provides unlimited coverage; Argentina provides fairly limited coverage; Canada is an intermediate case. The study examined how depositors responded to lower

loan quality (an increase in nonperforming loans) and bank capital. In Argentina, a decrease in a bank's loan quality or capital caused depositors to withdraw funds. However, in Mexico and Canada, where depositors know they are protected, deposit behavior is unaffected. Following financial market liberalization, banks in Mexico and Canada were adding increasingly risky loans to their portfolios. In Argentina, where depositors would have pulled out of banks taking on excessive risk, banks did not. Clearly, deposit insurance changes depositor behavior, reducing the incentive of depositors to monitor bank risk.

In the United States, the Comptroller of the Currency announced a "Too Big to Fail" policy in 1984. This policy provided 100 percent deposit insurance to the 11 largest banks in the United States.³⁶ This protection effectively lowered the cost of raising funds and meant that these banks could increase their exposure to high-yield (high-risk) loans. The stock market confirmed the benefits to the large banks; stock prices of large banks rose; stocks of small banks fell. Most troubling was the fact that stocks of weak large banks rose the most.³⁷

Judging from the stock market response, investors viewed the policy as a good deal for the large banks. In response to the "Too Big to Fail" policy, large banks took on more risk. Capital/asset ratios, holdings of safe securitized residential mortgages, and commercial loans to highly rated firms declined. Risky commercial real estate lending expanded.³⁸

Further evidence of the effect of insurance on monitoring risk taking comes from the international debt crisis of the 1980s.³⁹ This research examined U.S. banks in the face of the declining ability of less developed countries (LDCs) to stay current on their debt obligations. In particular, the researchers tried to determine whether LDC loan exposure had any impact on either the interest rate paid to holders of large, uninsured CDs or bank stock returns. If large CDs receive no guarantees, any increase in a bank's share of loans going to riskier developing countries should make depositors nervous. The result should be upward pressure on CD interest rates. The

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higher interest that investors demand as compensation for the extra risk associated with these loans puts a check on bank risk taking. Where deposits are fully guaranteed, we would expect to see no upward pressure on interest rates. That no relationship could be found between LDC loan exposure and interest paid on CDs reveals the power of depositor protection. Declining LDC loan quality should also reduce the return on bank stocks, but no decline in bank stock return was observed.⁴⁰

The last example of the perverse impact of a financial safety net comes from the life insurance industry in the United States.⁴¹ States have established life insurance guaranty funds to protect policyholders in the event that a company fails. If a company fails, the policyholders are paid with funds that come from assessments on surviving life insurance companies. This type of self-insurance system provides strong incentives for life insurance companies to monitor each other's investment strategies.

This self-regulating system has been short-circuited in some states by tax credits for surviving firms. In 43 states, surviving insurance companies can write off all or part of any assessment due to a failed company. The incentive to monitor and report risky investments of other insurance companies to regulators is reduced; taxpayers end up paying for any assessments that occur.

A comparison of insurance company risk before and after the introduction of tax credits suggests that risk taking goes up in states that allow tax credits for assessments. In states that do not allow tax credits, risk taking does not increase. Self-monitoring helps to maintain a stable level of life insurance company risk.

Taken together, the results of the studies referred to here provide powerful evidence of moral hazard behavior in financial markets. Insurance and other protections (such as tax credits) encourage risk taking beyond what is desirable in financial markets. Clearly, the moral hazard problem associated with IMF or government bailouts and guarantees should be taken seriously. Once the government steps in to protect individuals from bad outcomes, the incentive to monitor the behavior of financial institutions declines. With less monitoring, risk taking

increases. Greater risk taking increases the chances that a financial crisis will occur. The costs must be weighed against any benefits that can be derived from the interventionist policies.

The Effectiveness of IMF Adjustment Programs

The IMF has been a major player in the post-World War II global financial system. The IMF's mission was to help manage the fixed exchange rate system established by the 1944 Bretton Woods agreement.⁴² The fund would make short-term loans to member countries experiencing balance-of-payments difficulties. The move to flexible exchange rates in 1973 effectively ended this mission.⁴³

The Third World debt crisis, beginning in 1982, led to a reinvention of the IMF as a source of funding and advice to developing economies experiencing debt problems. This resulted in a significant increase in IMF resources and influence.⁴⁴

Critics argue that this is a poor use of funds and that IMF programs should be suspended. On the other side are those who laud the benefits of IMF interventions in speeding economic recoveries in the wake of financial crises. At issue is the effectiveness of IMF-led country adjustment programs.

Many studies have examined the impact of IMF-designed country adjustment programs.⁴⁵ Most evaluations focus on the program's impact on a faltering country's current account balance, international reserve position, rate of inflation, and output growth. What is striking is how difficult it is to find evidence showing that the fund's programs significantly improve economic performance.

The IMF's own review of this research is not very positive. After examining 18 different studies, IMF researchers concluded that 4 of 14 studies found that adjustment programs significantly improved a country's current account balance.⁴⁶ International reserves significantly increased, according to 5 of 15 studies. The impact of fund policies toward inflation and output growth is smaller still. Inflation significantly declined, said 3 of 17 studies. Output

growth significantly increased, according to only 3 of 18 studies. Two of the negative studies found that output growth significantly increased following the initial decline.

More recent studies do a better job of controlling for factors beyond the IMF's control. They report a somewhat higher success rate. In particular, a stronger case can be made that IMF adjustment programs improve a country's current account balance. However, even with better analysis, the evidence on the remaining variables is mixed. Overall, IMF adjustment programs do not have a good record.

An alternative way to evaluate the success of the IMF programs is to compare recovery from financial crises before and after the creation of the IMF. For the comparison to be meaningful, the size of the international capital flows must be comparable. Just such a comparison can be made with the 30-year period preceding World War I.⁴⁷ During that period, capital flows were comparable in size to recent flows.⁴⁸

A recent comparison generally found emerging market crises to be more frequent in the current period. Drops in output relative to trend during a crisis averaged 2 percent in the early period and 3 percent during the past 25 years.⁴⁹

Emerging market economies recovered faster following a currency crisis in the earlier period than in more recent times. However, countries recovered more slowly from banking crises in the earlier period. The second result is likely due to the absence of a domestic lender of last resort. The evidence indicates that IMF programs have not been successful in facilitating adjustments to financial crises.

Reforming the International Financial system

There is no shortage of proposals for improving the international financial system.⁵⁰ This paper focuses on the IMF and domestic policy adjustments. These two areas are closely related and at the heart of improving global capital markets.

Stanley Fischer, an economist and first deputy managing director of the IMF, has

argued that the fund should serve as an international lender of last resort.⁵¹ Despite the evidence to the contrary, Fisher believes herding is significant in international capital markets, creating a serious contagion problem. He would like to see the role of the IMF in international markets expanded.

A number of economists have challenged the notion that the IMF can serve as an effective international lender of last resort.⁵² A lender of last resort must be able to act quickly to provide almost unlimited loans to solvent financial institutions with marketable collateral. It is generally agreed that those loans must be at or above market interest rates to discourage improper use of the funds.⁵³

Without the ability to create high-powered money (currency plus bank reserves), the IMF cannot provide sufficient funds during a crisis.⁵⁴ It has never shown an ability to act quickly in a crisis. Its executive directors generally must consult with their home country governments before voting, delaying the process. The IMF's track record in financial crises is not good. It has consistently made loans at below-market rates, encouraging inefficient use of funds. Political pressure has led to lending to insolvent governments like Russia's. Furthermore, central banks already stand by to provide liquidity to the financial system if there should be a run on banks.

Lenders of last resort should not provide funds to individual institutions in financial trouble. Instead, a lender of last resort should increase liquidity for the financial system as a whole. This allows the market to allocate the new funds in the most efficient manner. Some financial institutions will (and should) fail.

The politics of the IMF have led it to provide funds to governments whose financial problems result from bad decisions. This is inconsistent with most views of how a lender of last resort should act, and clearly works to worsen the moral hazard problem. Irresponsible governments know the IMF will step in to save them from bearing the consequences of financial imprudence.

The goal of international financial reform is to reduce the frequency and severity of financial crises. This can be accomplished only if emerging economies adopt a series of reforms.⁵⁵ These

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reforms include greater macroeconomic stability (by instituting greater fiscal discipline and monetary control), tax reform, flexible exchange rates, free trade in goods and assets, market-based financial regulation, improved accounting standards and disclosure, and a legal system that protects private property rights.⁵⁶

Reforming the international financial system boils down to two closely linked questions. Does the current system with the IMF playing the lead role in managing financial crises provide the right incentives for emerging-market reform? Would an alternative system work better?

The history of the IMF reveals a track record of providing weak incentives for domestic reform. The fund tries to influence domestic policies by imposing conditions on its loans to financially troubled countries; countries must agree to a set of macroeconomic policies and targets before receiving financial help. The macroeconomic policies are ostensibly set to move a country onto a sustainable long-term growth path. In theory, once the reforms are in place and the loan is repaid, the country no longer requires IMF aid.

Unfortunately, that is not the typical outcome. Macroeconomic policies that are conditions to the loans are negotiated politically and have not been enforced. Economist Sebastian Edwards puts it rather bluntly:

In many cases, by approving standby programs whose targets everyone knows will not be met, the IMF is participating in a big charade; it is implicitly saying that, according to the articles of agreement, the resources have been provided on a temporary basis, and there is a high probability that the country will attain balance of payments viability in the near future. For many countries this is not the case and everyone knows it.⁵⁷

Rather than promote long-run economic growth, the fund has promoted dependence. This is reflected in the high proportion of member countries that are regular (and in some cases annual) borrowers from the fund.⁵⁸ Between

1949 and 1999, 24 countries used IMF funds for 30 years or more. Egypt, India, Turkey, and Yugoslavia used IMF funds for 40 years or more. Forty-six countries borrowed from the IMF between 20 to 29 times, and 25 countries borrowed from the IMF 10 to 19 times.⁵⁹

The IMF has not been able to resolve debt repayment problems in a timely fashion. During the debt crisis of the 1980s, the expansion of IMF lending delayed needed adjustments.⁶⁰ IMF loans made private banks less willing to settle accounts on overdue loans. The banks knew that funds would be forthcoming from the IMF and that those funds could be used to repay the banks. It took nearly 10 years to resolve the crisis. Without IMF intervention, the private market would have negotiated a resolution to the crisis in less time.

IMF programs do not provide the necessary incentives for emerging countries to implement needed economic reforms. Only the private market can do that in a credible manner. The threat of the loss of private funding creates strong incentives for reform—something the IMF is incapable of doing.

Successful long-term reform of the IMF is unlikely. The managerial bureaucracy at the fund is adept at expanding its mission in order to survive. The IMF's original mission effectively ended when the major industrialized economies of the world moved to a flexible exchange rate system in 1973. Despite that development, the fund has managed to expand its resources and power since that time. This is a troubling development given the fund's ineffective track record.

The IMF will always claim that it serves the public interest. Yet public choice economic analysis suggests that it is naive to think that bureaucracies like the IMF are motivated purely by disinterested concern for the common weal. For example, if the fund is providing a public service to the taxpayers of the world, we would expect to see staffing increases during periods when its members are experiencing financial problems. That is not the case. Studies show there is no significant relationship between global economic problems and staff growth.⁶¹ In addition, there is little con-

cern about operating cost. Staff growth is generally unrelated to labor costs. Generally, the greater the funds available to the IMF, the larger the staff.

According to the IMF charter, total member contributions are reviewed every five years. IMF management uses the five-year review to its advantage. To make the case for greater resources, it increases lending in the two years preceding quota review. IMF credits increase, on average, 52 percent in the year before a review. After controlling for member demand for credit, a significant pattern of increased utilization was found in the two years preceding review.⁹² This pattern creates the image of an urgent need for greater resources. The practice puts pressure on members to increase contributions.

The IMF bureaucracy should not be reformed; it should be closed down. The private market is capable of providing incentives for reform and has the incentive to work out debt repayment problems in a more timely manner when they occur. IMF actions in global financial markets provide a poor return on taxpayer dollars. Although the United States cannot unilaterally close down the IMF, it should stop providing funds to the fund. Furthermore, it should encourage other members to do the same.

Conclusion

Policymakers need to understand four key points if they desire to improve the operation of the international financial system:

- Open capital markets promote investment, efficiency, and economic growth that lead to improved standards of living.
- Controls on international capital flows harm economic performance and should be avoided.
- Government and IMF bailouts lead to excessive risk taking that worsens and increases the chances of financial crises.
- IMF lending and adjustment programs are ineffective and harmful. The United States should stop funding the IMF.

Calls for a new international financial architecture that would include controls on international capital flows may be politically expedient, but they will be harmful to the global economy. Allowing international capital markets to determine how funds are used is the best way to raise the living standards of the world's poor.

A larger role for the IMF in the international economy will neither reduce the frequency and severity of financial crises nor promote reform. The best course of action is to allow private markets to manage international financial problems that arise. Pressure by private investors will provide the incentives for emerging-market governments to carry out needed economic reforms that will lead to sustained long-term economic growth.

Notes

1. Maurice Obstfeld, "The Global Capital Market: Benefactor or Menace," *Journal of Economic Perspectives* 12, no. 4 (Fall 1998): 9-30; Barry Eichengreen and Michael Mussa, *Capital Account Liberalization: Theoretical and Practical Aspects*, IMF Occasional Paper 172, Washington, 1998; and Ross Levine, "Foreign Bank Entry and Capital Control Liberalization: Effects on Growth and Stability," September 1999, unpublished manuscript in author's file.

2. In the low-saving country, the additional welfare gains going to borrowers exceed any welfare loss to the lenders. In the high-saving country, the additional welfare gains going to the lenders exceed any welfare loss to borrowers. For details, see Andrew B. Abel and Ben S. Bernanke, *Macroeconomics* 3d ed. (Reading, Mass.: Addison-Wesley Longman, 1998), pp. 143-80; and Maurice Obstfeld and Kenneth Rogoff, *Foundations of International Macroeconomics* (Cambridge, Mass.: MIT Press, 1996), pp. 1-58.

3. See Peter Blair Henry, "Do Stock Market Liberalizations Cause Investment Booms?" *Journal of Financial Economics* 58, no. 2 (October 2000): 301-34; and Geert Bekaert and Campbell R. Harvey, "Time-Varying World Market Integration," *Journal of Finance* 55, no. 2 (June 1995): 403-44.

4. Geert Bekaert and Campbell R. Harvey, "Foreign Speculators and Emerging Equity Markets," *Journal of Finance* 55, no. 2 (April 2000): 56-613.

Allowing international capital markets to determine how funds are used is the best way to raise the living standards of the world's poor.

5. These results draw on Dennis Quinn, "The Correlates of Change in International Financial Regulation," *American Political Science Review* 91, no. 3 (September 1997): 531-51; and Robert Krol, "Capital Controls, Financial Development, and Economic Growth," January 2000. unpublished manuscript in author's files.
6. Estimates suggest that an increase of one standard deviation in an index of capital account openness results in a little more than a one-half of a percent increase in annual output growth. Over a 10-year period, this amounts to an almost 6 percent increase in real per capita GDP. The index of capital account openness is from Quinn, p. 545.
7. See Bruno Solnik, *International Investment* (Reading, Mass.: Addison-Wesley Longman, 1999), p. 126.
8. Ibid.
9. Open financial markets will also allow domestic banks to diversify their loan portfolios regionally within a country, and between countries. Any adverse economic performance in a region, sector, or trading partner country will have less of an impact on bank profits and solvency.
10. See Obstfeld and Rogoff, pp. 82-84.
11. See Asli Demirguc-Kunt, Ross Levine, and Hong G. Min, "Opening to Foreign Banks: Issues of Stability, Efficiency, and Growth," in *The Implications of Globalization of World Financial Markets*, ed. Seongtae Lee (Seoul: Bank of Korea, 1998); and Levine.
12. This section's discussion is based on Stijn Claessens, Asli Demirguc-Kunt, and Huizinga, "How Does Foreign Entry Affect the Domestic Banking Market?" World Bank Policy Research Working Paper 1918, June 1998; and Levine.
13. Additional U.S. evidence on the positive impact of open banking systems on economic activity can be found in Robert Krol and Shirley Svorny, "The Effect of the Bank Regulatory Environment on State Economic Activity," *Regional Science and Urban Economics* 26, no. 5 (August 1996): 531-41.
14. See Robert Krol and John Ortensi, "The Impact of Financial Development on Growth in Emerging Economies," *Jobs & Capital* 7, no. 2 (Spring 1998): 18-25; and Ross Levine and Sara Zervos, "Capital Control, Liberalization, and Stock Market Development," *World Development* 26, no. 7 (July 1998): 1169-83.
15. See Nils Pratle, "U.S. Defends Soros After Attack by Malaysia's PM," *Daily Telegraph* (London), July 28, 1997.
16. See Sushil Bikhchandani and Sunil Sharma, "Herd Behavior in Financial Markets: A Review," IMF Working Paper no. 48, March 2000, p. 4.
17. This section draws heavily on Rene M. Stulz, "International Portfolio Flows and Security Markets," August 1997, unpublished manuscript in author's files.
18. See Kristen Forbes and Roberto Rigobon, "No Contagion, Only Interdependence: Measuring Stock Market Co-Movements," National Bureau of Economic Research Working Paper no. 7767, July 1999; and Mico Loretan and William B. English, "Evaluating 'Correlation Breakdowns' during Periods of Market Volatility," Board of Governors of the Federal Reserve System, International Finance Discussion Paper no. 658, February 2000.
19. See Josef Lakonishok, Andrei Shleifer, and Robert Vishay, "The Impact of Institutional Trading on Stock Prices," *Journal of Financial Economics* 32, no. 1 (August 1992): 23-43; Woonchan Kim and Shang-Jin Wei, "Offshore Investment Funds: Monsters in Emerging Markets?" National Bureau of Economic Research Working Paper no. 7133, May 1999; and W. L. Lin and T. Ito, "Price Volatility and Volume Spillovers between Tokyo and New York Stock Markets," in *The Internationalization of Equity Markets*, ed. Jeffrey Frenkel (Chicago: University of Chicago Press, 1994); and Bikhchandani and Sharma.
20. See Geert Bekaert and Campbell R. Harvey, "Emerging Equity Market Volatility," *Journal of Financial Economics* 43, no. 1 (January 1997): 29-77.
21. See Stijn Claessens, Michael Dooley, and Andrew Warner, "Portfolio Capital Flows: Hot or Cool?" *World Bank Review* 9, no. 1 (January 1995): 153-74.
22. Much of this discussion is based on Geert Bekaert and Campbell R. Harvey, "Capital Markets: An Engine for Economic Growth," *Brown Journal of World Affairs* 5, no. 1 (Winter-Spring 1998): 33-53.
23. These results are based on studies by Stephen J. Brown, William N. Goetzmann, and James Park, "Hedge Funds and the Asian Currency Crisis of 1997," National Bureau of Economic Research Working Paper no. 6427, February 1998; and "Do Foreign Investors Destabilize Stock Markets? The Korean Experience in 1997," October 1998, unpublished manuscript in author's files.
24. Studies of hedge fund behavior provide evidence that negative feedback trading is fairly com-

- mon. See William P. Osterberg and James B. Thomson, "The Truth about Hedge Funds," *Economic Commentary of the Federal Reserve Bank of Cleveland*, May 1999.
25. See Hyuk Choe, Bong-Chan Kho, and Rene M. Stulz, "Do Foreign Investors Destabilize the Stock Market? The Korean Experience in 1997," *Journal of Financial Economics* 54, no. 2 (October 1999): 227–64.
26. See, for example, International Financial Institution Advisory Commission, *The Final Report of the International Financial Institution Advisory Commission* (Washington: International Financial Institution Advisory Commission, March 2000).
27. Insuring an individual against adverse outcomes associated with a particular activity increases the incentives to take on more risk. This is called moral hazard. Government financial safety nets, such as deposit insurance, create moral hazard problems. They are designed to protect depositors when a bank fails and to prevent a run on one bank from spreading to other banks. If bank runs are limited, the financial system is more stable and safe. However, because depositors are protected, they have less of an incentive to monitor the loan decisions of banks. With less monitoring, bankers may gamble for a high payoff by making riskier loans.
28. Michael Bordo and Anna J. Schwartz, "Measuring Real Economic Effects of Bailouts: Historical Perspectives on How Countries in Financial Distress Have Fared with and without Bailouts," National Bureau of Economic Research Working Paper 7701, May 2000, p. 30.
29. See Allan H. Meltzer, "What's Wrong with the IMF? What Would Be Better?" *Independent Review* 4, no. 2 (Fall 1999): 201–15; and Bordo and Schwartz.
30. See Bradford De Long, Christopher De Long, and Sherman Robinson, "The Case for Mexico's Rescue," *Foreign Affairs* 75, no. 3 (May–June 1996): 8–14.
31. See Bordo and Schwartz; Meltzer; and Robert Krol, "Bailout Bickering," *Foreign Affairs* 75, no. 5 (September–October 1996): 171.
32. See Bordo and Schwartz.
33. See Robert Krol, "Tighter Reins on IMF Lending," *Washington Times*, March 30, 2000.
34. See Asli Demirguc-Kunt and Enrica Detragiache, "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation," IMF Working Paper, 1999.
35. See William Gruben, Jahyeong Koo, and Robert Moore, "When Does Financial Liberalization Make Banks Risky? An Empirical Examination of Argentina, Canada, and Mexico," Federal Reserve Bank of Dallas Working Paper 99-05, August 1999.
36. The Federal Deposit Insurance Improvement Act of 1991 placed limits on the "Too Big to Fail" policy. While an improvement, this legislation has not been tested by a U.S. financial crisis.
37. These results are based on Maureen O'Hara and Wayne Shaw, "Deposit Insurance and Wealth Effects: The Value of Being Too Big to Fail," *Journal of Finance* 45, no. 6 (December 1990): 1587–1600.
38. See John H. Boyd and Mark Gertler, "The Role of Large Banks in the Recent U.S. Banking Crisis," *Federal Reserve Bank of Minneapolis Quarterly Review* 18, no. 1 (Winter 1994): 2–21.
39. This discussion draws on Christopher James, "Empirical Evidence on Implicit Government Guarantees of Bank Foreign Loan Exposure," *Carnegie-Rochester Conference Series on Public Policy* 30 (Spring 1989): 129–62, and a comment on the paper by Jeremy Bulow in the same journal.
40. Other studies of bank stock returns and international debt problems found only partial insurance for stockholders.
41. This discussion is based on Elijah Brewer, Thomas Mondschean, and Philip Stratan, "The Role of Monitoring in Reducing the Moral Hazard Problem Associated with Government Guarantees: Evidence from the Life Insurance Industry," *Journal of Risk and Insurance* 64, no. 2 (June 1997): 301–22.
42. This section draws on Ian Vásquez, "Repairing the Lender-Borrower Relationship in International Finance," Cato Institute Foreign Policy Briefing no. 54, September 27, 1999, pp. 1–13; and Meltzer.
43. Milton Friedman makes this point in "Markets to the Rescue," *Wall Street Journal*, October 13, 1998.
44. See Vásquez; and Meltzer.
45. This section draws on a survey paper by IMF economists Nadeem Ul Haque and Mohsin S. Khan, "Do IMF-Supported Programs Work? A Survey of the Cross-Country Empirical Evidence," IMF Working Paper 169, December 1998.
46. Even though Ul Haque and Khan reviewed 18 studies, not every study looked at all four macro-

- economic variables. As a result, the total number of studies reported for each variable may be fewer than 18.
47. For a discussion of this issue see Jeffrey Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity* no. 1 (1995): 1-118; and Michael D. Bordo, Barry Eichengreen, and Douglas A. Irwin, "Is Globalization Today Really Different Than Globalization a Hundred Years Ago?" National Bureau of Economic Research Working Paper no. 7195, June 1999.
48. There were two important differences between the two periods. During the early period, the world economy was on a gold standard and governments intervened far less in global capital markets. There was no IMF or World Bank.
49. This comparison comes from Bordo and Schwartz, pp. 45-60.
50. See Robert A. Blecker, *Taming Global Finance* (Washington: Economic Policy Institute, 1999); Barry Eichengreen, "Toward a New International Financial Architecture," Institute for International Economics, Washington, 1999; Morris Goldstein, *Safeguarding Prosperity in a Global Financial System* (New York: Council on Foreign Relations, 1999); Jane Little and Giovanni P. Olivei, *Rethinking the International Monetary System* (Boston: Federal Reserve Bank of Boston, 1999); and International Financial Institution Advisory Commission.
51. See Stanley Fischer, "On the Need for an International Lender of Last Resort," *Journal of Economic Perspectives* 13, no. 4 (Fall 1999): 85-104. Paul Krugman has also made this argument in "The Indispensable IMF," *New York Times*, May 15, 1998.
52. See Varadarajan V. Chari and Pat Kehoe, "Asking the Right Questions about the IMF," *Federal Reserve Bank of Minneapolis Annual Report 1998*; Milton Friedman, "Markets to the Rescue," *Wall Street Journal*, October 13, 1998; George P. Shultz, William E. Simon, and Walter B. Wriston, "Who Needs the IMF?" *Wall Street Journal*, February 3, 1998; Anna J. Schwartz, "Time to Terminate the ESF and the IMF," Cato Institute Foreign Policy Briefing no. 48, August 26, 1998; and Charles W. Calomiris, "The IMF's Imprudent Role as Lender of Last Resort," *Cato Journal* 17, no. 3 (Winter 1999): 275-94.
53. Xavier Freixas and Jean-Charles Rochet, *Microeconomics of Banking* (Cambridge, Mass.: MIT Press, 1998), pp. 207-10.
54. This argument comes from Schwartz.
55. Since most of the reforms are now well-known and have been discussed elsewhere, I simply list them. For more details see Krol and Ortenzi or Eichengreen.
56. Some free-market economists prefer a currency board or the complete elimination of a country's currency to greater exchange rate flexibility. See, for example, Carlos E. Zarazaga, "Can Currency Boards Prevent Devaluations and Financial Meltdowns?" *Federal Reserve Bank of Dallas Southwest Economy* 4 (1995): 6-9; and Steve H. Hanke and Kurt Schuler, "A Dollarization Blueprint for Argentina," Cato Institute Foreign Policy Briefing no. 52, March 12, 1999.
57. Sebastian Edwards, "The International Monetary Fund and Developing Countries: A Critical Evaluation," *Carnegie-Rochester Conference Series on Public Policy* 31 (1989): 35.
58. See Doug Bandow, "The IMF: A Record of Addiction and Failure," in *Perpetuating Poverty: The World Bank, the IMF, and the Developing World*, ed. Doug Bandow and Ian Vásquez (Washington: Cato Institute, 1994), pp. 18-20.
59. These figures come from the International Financial Institution Advisory Commission, p. 16.
60. This conclusion is based on Jeremy Bulow and Kenneth Rogoff, "Debt Relief and the International Enforcement of Loan Contracts," *Journal of Economic Perspectives* 4, no. 1 (Winter 1990): 31-42.
61. This evidence comes from Roland Vaubel, "The Political Economy of the International Monetary Fund: A Public Choice Analysis," in *The Political Economy of International Organizations: A Public Choice Approach*, ed. Roland Vaubel and Thomas D. Willett (Boulder, Colo.: Westview, 1991), pp. 204-44; and Roland Vaubel, "Bureaucracy at the IMF and the World Bank: A Comparison of the Evidence," *World Economy* 19, no. 2 (March 1996): 195-210.
62. See Vaubel, "The Political Economy of the International Monetary Fund."

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