New Stock Market Regulations Unneeded

An issue receiving attention that should not be a priority for the next president is the stock and stock index futures markets. Following the sharp drop in stock prices in October, there have been numerous calls for additional federal regulation to fix our financial markets, especially for repairing the linkages between the stock market and the stock index futures and stock index options markets. These calls have come from many quarters, most notably from former Senator Nicholas Brady, chairman of the Presidential Task Force on Market Mechanisms, and John Phelan, chairman of the New York Stock Exchange. In the numerous lengthy and detailed studies of the events of October 13 to October 23 that have been delivered to congressional committees, there is little evidence that the market "broke" in October, or that the market requires a federal mechanic to fix it.

The stock price decline of October 19 was not a technical aberration caused by program trading related to stock index futures as many now claim. The fact that the stock market has not rebounded since October provides strong evidence that there has been a fundamental realignment of stock prices reflecting a broadly based change in investors' expectations. The adjustment was abrupt. Technical fixes of the type being proposed—from realignments of regulatory jurisdictions, to increasing margins on futures, to price limits and trading halts, to outright bans on program trading—could not have stopped the rapid realignment of prices in October nor will they prevent such adjustments in the future.

This is not to say that no changes are needed. The market must accommodate the greater trading volume now demanded and the growing demand to trade baskets of stocks whether directly in the cash market or through the futures market. The stock and futures exchanges, though, have substantial incentives, especially with a little nudge from the existing cast of regulators, to make those changes that are necessary. Major new federal regulations are not required.

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"We should not penalize growth and productivity by taxing capital and saving."

The main task for the next administration is to improve the performance of the U.S. and the world economy by reducing uncertainty and increasing efficiency. By adopting three policies the next administration should provide a framework for more stable, nonflationary growth of the world's market economies.

1) Stabilize domestic prices and exchange rates. Domestic prices can be stabilized by an adaptive, medium-term monetary policy that holds the rate of money growth equal to the difference between a three-year moving average rate of increase of real output and a similar average of the growth of monetary velocity.

Stability of exchange rates would be increased if other major countries—Germany, Japan, and perhaps Britain—adopt comparable medium-term policies for price stability. Germany and Japan followed medium-term monetary policies of this type in recent years, until they were induced to support the dollar.

2) Lower tariff and nontariff barriers, remove recent quotas and restrictions, and improve enforcement. Trade increases efficiency and raises standards of living by encouraging countries to shift resources toward more efficient, higher value uses. Debtor countries, including the United States, will have much less difficulty servicing past debts by exporting if world trade is expanding, so this policy helps to make the servicing of international debt more manageable.

Rules for trade adopted in the early postwar period under the General Agreement on Tariffs and Trade (GATT) have been undercut by protectionist actions, exclusions, and the absence of enforcement procedures. The challenge to the next administration is to expand the coverage and to improve the procedures for enforcing the new and old rules.

3) Shift resources from consumption to investment by shifting taxes from capital and saving toward consumption and by reducing the growth of government spending. We should not penalize growth and productivity by taxing capital and saving. We should slow the growth of transfers and government consumption by adopting a spending limitation amendment.

The problem that should *not* be given top priority is the so-called twin deficits. The efficiency with which we use resources and division of resources between consumption and investment and between government and the private sector are far more important than the budget deficit. If we hold the growth of government spending below the growth of GNP, the budget deficit will fall without tax-rate increases or spending cuts. Further, the policies often recommended to bring down the twin deficits—tax increases and protection or retaliation—are costly. However, we should convince foreign governments to share more of the costs of common defense efforts and to join with us in lowering trade barriers.

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"The biggest nonproblem is the trade balance."

The first priority is to apply realistic cost-benefit analysis to every government spending program, including entitlements. The big spenders have always had an air of moral superiority; they seem to think that they are the compassionate ones. But they never look at the extraction costs—the costs to the private sector of the taxation and government borrowing needed to finance spending programs. Once these extraction costs are included in the analysis, the evidence shows that most government spending programs diminish the social welfare rather than increase it. It is also obvious that the federal budgetary process has completely broken down. We need to fix that process both constitutionally and procedurally.

The second priority is greater stability in monetary policy. As the United States and other nations become part of a worldwide economy, extreme fluctuations in domestic monetary policies are causing wide exchange rate swings and erratic domestic price fluctuations that diminish investment levels and, ultimately, economic growth. To reduce monetary instability and rapid price swings, we need to move toward international price standards such as a basket of commodities or gold.

The third priority is further tax reform. We've made great progress in lowering destructively high marginal tax rates, but we still penalize productive savings and investment. A more neutral tax system would lead to greater economic growth. Specifically we need to reduce the capital gains tax rate and develop more vehicles for tax-exempt or at least tax-deferred savings by individuals and businesses.

The biggest nonproblem is the trade balance, which in a world of freely floating exchange rates is self-correcting. If people around the world do not think that the United States is a good place to invest their money, the dollar will decline, correcting the trade imbalance. If people think that the United States is a good place to invest, the trade deficit will increase, but that won't matter provided we are using these investment funds in a productive manner. Most proposals for reducing the trade deficit, such as trade protectionism or direct monetary intervention to affect the value of the dollar, are cures far worse than the disease.

"Our grandchildren will be left to pay the bill for our profligacy."

Thomas Jefferson warned America that we must make our choice between liberty and economy, or profusion and servitude. For two decades, the American people have freely chosen to follow the path of profusion, bringing us ever closer to an economic point of no return.

The next administration must confront a new choice: either take immediate, decisive, and effective action to rein in our years of excess, or risk presiding over a country that will plunge into national bankruptcy.

We face three immediate challenges:

First, we must cut sharply the catastrophic federal budget deficit of $150 to $200 billion per year, and the accumulated interest burdens of the federal debt, which have more than doubled over the past seven years.

Second, we must reform a congressional budgetary process that has gone completely amuck, imposing no meaningful disciplines on spending and granting the president no authority to match revenues with outlays in a responsible fashion.

Third, we must relieve the private enterprise system from the enormous burdens of federal regulations and red tape, which are smothering risk taking and stifling growth.

These problems are not dissimilar to those confronting Ronald Reagan when he took the oath of office in 1981, except that they have increased dramatically in magnitude during the past seven years. The federal deficit was already a serious problem in 1981; today, it is a malignant cancer eating away at the foundations of our economic freedoms. The congressional budget process in 1981 was clearly an irrational method for allocating government resources and matching revenues with outlays. Today, the whole process has become a grotesque caricature of its original intent, with Congress dumping massive reconciliation bills on the president's desk only hours before the government is to close down entirely for lack of funds.

In 1981, Washington had earned a well-deserved reputation for maniacally trying to regulate every aspect of our lives. Yet, after various task forces have submitted their reports, the problem of excessive regulation remains very serious. While we have made progress in eliminating some of the most self-defeating regulations and in reducing the burdens of confiscatory marginal tax rates, much remains to be done if we are to recover the vitality that once