

EDITOR'S NOTE

The Cato Institute held its 27th Annual Monetary Conference—**Restoring Global Financial Stability**—on November 19, 2009. The articles in this issue of the *Cato Journal*, except those by James Buchanan, Deepak Lal, and Charles Calomiris, were first presented at that conference. Additional articles from the conference will appear in the next issue.¹ The Cato Institute gratefully acknowledges the generous support of **Steve G. Stevanovich** to the production of these two special issues of the *Cato Journal*.

The financial crisis, which began in the U.S. subprime mortgage market in 2007 and spread in 2008 to the global economy, raises a fundamental question: What is the role of government in creating financial harmony? There is little doubt that the financial crisis was due to policy errors as well as misjudgments in the private sector. Federal housing policy in conjunction with monetary and fiscal policy distorted the allocation of credit and helped fuel an asset bubble. Private lenders overleveraged and called on Washington for bailouts. In the end, both the federal government and the Federal Reserve expanded their size and scope. The articles in this volume shed light on the causes of the crisis, the proper balance between government and the market in bringing about financial stability, and the reforms needed to ensure that the too-big-to-fail problem does not destroy financial harmony in the future.

In the lead article, Nobel economist *James Buchanan* argues that the United States needs a monetary constitution to protect the long-run value of money. In a world of pure fiat money, there must be some transparent rule that limits the quantity of money in order to lend predictability to its value. Unless that rule is explicitly anchored in the basic law of the land, discretionary monetary policy and a fractional reserve banking system will lead to crises of confidence.

Zanny Minton Beddoes, economics editor for *The Economist*, warns that the financial crisis has tilted the balance between government and the

¹Contributors to the Fall 2010 issue (vol. 30, no. 3) include Leland Yeager, Bennett McCallum, Lawrence H. White, George Selgin, Miranda Xafa, Swaminathan S. Anklesaria Aiyar, Judy Shelton, James Grant, Richard Rahn, and Luigi Zingales.

market toward the former, and that the challenge will be to restore the proper balance and ensure that global distortions are corrected—including the underpricing of risk. The socialization of losses and the privatization of profits is a recipe for financial chaos, not harmony.

Deepak Lal, a noted development economist, points to numerous policy errors leading to the “Great Crash of 2008.” Those who blame the crisis on “market failure” would do well to study his detailed analysis of government failure. One of the most serious consequences of the crisis, according to Lal, may be the loss of U.S. leadership and the erosion of the global liberal order, as the U.S. debt burden mushrooms.

Allan H. Meltzer, a leading monetary economist at Carnegie-Mellon University and author of the monumental *History of the Federal Reserve*, provides an overview of Fed performance and argues that there is too much attention paid to the short-run goal of full employment and too little to the long-run goal of price stability. In his view, the Fed should pay more attention to money growth and adopt a rule to limit discretion. The absence of a monetary rule means that the Fed will be under great pressure to finance budget deficits and risk inflation in so doing. Moreover, there will be increasing pressure for banks to lend out their excess reserves as the economy recovers.

Charles Calomiris, an expert on financial regulation at Columbia University, like others, argues for a clear rule for the conduct of monetary policy and favors a Taylor-type rule. The Fed, meanwhile, should limit its prudential macro regulation to a few functions—such as setting minimum capital and liquidity standards, with higher capital ratios required during boom years. He would also revise the bankruptcy code to better resolve insolvent banks and nonbank financial institutions. Again, he prefers a rules-based approach to discretion and politicization.

Richard Fisher, president of the Federal Reserve Bank of Dallas, makes a strong case against the “too-big-to-fail” doctrine. Failure is an important part of a vibrant financial sector. Market discipline does work. Banks and nonbank financial institutions should not be allowed to grow so large that they pose a systemic risk and distort the monetary transmission process. The problem is to strike the right balance. Fisher would “roll back various pieces of the government’s safety net” so that creditors rather than taxpayers bear the risks of failure.

Thomas Humphrey, a historian of monetary thought and a former vice president and economist at the Federal Reserve Bank of Richmond, reviews the characteristics of a classical lender of last resort. Walter Bagehot’s famous rule is that the central bank should not bail out insolvent banks but should supply pre-announced emergency loans of high-

powered money during a liquidity crisis, provided the loans are made on the basis of good collateral and at a penalty rate. The Fed has departed from that norm and has acquired billions of dollars of toxic assets; it has engaged in credit allocation, not pure monetary policy; and it has vastly expanded its powers. This change of status has created uncertainty. The Fed would do well to adopt a classical role of lender of last resort, argues Humphrey, manage its balance sheet in line with monetary equilibrium, and avoid engaging in credit/fiscal policy.

George Melloan, author of *The Great Money Binge* and longtime editor/columnist at the *Wall Street Journal*, attributes much of the financial chaos of the last several years to government intervention. His main point is that “it is the nature of governments to first interfere with market forces and then make the problem worse by addressing the resulting confusions and dislocations by interfering still more.” The real solution, he argues, is to strengthen capital markets by limiting government distortions, exercise sound fiscal and monetary policy, and liquidate government-sponsored enterprises—namely, Fannie Mae and Freddie Mac.

William Poole, former president of the Federal Reserve Bank of St. Louis and a senior fellow at the Cato Institute, holds that the Fed should not attempt to peg the dollar's foreign exchange value. Rather, monetary policy ought to be aimed *primarily* at safeguarding the *domestic* purchasing power of the dollar. Success in that task would help achieve full employment. He concludes that the Fed should follow “a benign policy toward the dollar”—that is, “neither a strong nor a weak dollar policy.”

Eswar Prasad, a specialist in international economics at Cornell University and a senior fellow at the Brookings Institution, advises that the “United States needs to get its fiscal house in order” to help resolve global imbalances and generate financial stability. Washington should work with other members of the Group of Twenty to prevent economic nationalism and the loss of wealth that would result from a rise of protectionism.

Benn Steil, director of international economics at the Council on Foreign Relations, argues that excessive debt—both private and public—was an important feature of the financial crisis and that government policy was the underlying cause of that excess. So far little has been done to stem “policy-induced systemic risks,” he warns. Indeed, there has been no tax reform to encourage saving and investment and to reduce the bias toward debt financing. Moreover, the federal government now guarantees nearly all mortgages and the Federal Housing Association's leverage is 50 to 1.

In the final article, *Peter Wallison*, a financial expert at the American Enterprise Institute, paints a vivid picture of the harmful role federal

housing policy played in causing the financial crisis. By underpricing mortgages and encouraging loans to high-risk borrowers, the federal government created a giant moral hazard problem. The Community Reinvestment Act and other housing policies provided strong incentives to expand subprime and Alt-A mortgages, especially since they could be securitized. Fannie and Freddie failed to disclose the true nature of their portfolios, and when housing prices began their steep decline, defaults soared. The perverse incentives underlying the failed policies were revealed.

These articles provide a careful analysis of the global financial crisis and the steps that need to be taken to avoid another crisis in the future. Creating financial harmony will require free markets, sound money, limited government, and a legal/constitutional framework that makes individuals and firms responsible for their actions. The challenge will be to strike the right balance between state and market.

The articles in the next issue of the *Cato Journal* will address that challenge and offer alternatives to the present discretionary government fiat money regime and consider market-based rules to create financial harmony.

—J. A. Dorn