28th Annual Monetary Conference

Asset Bubbles and Monetary Policy

November marked the 28th year of Cato's Annual Monetary Conference directed by Cato vice president for academic affairs James A. Dorn. In a year marked by another round of quantitative easing, massive federal spending, and promises of much more, leading experts came together to consider the role of monetary policy in preventing financial instability and the function of asset prices in guiding policy.

The conference, which "drew a standing-room-only crowd," as the *New York Times* noted, addressed a key issue underlying the 2008 financial crisis: Did the Federal Reserve contribute to the crisis by keeping interest rates too low for too long? Would a more restrictive monetary policy have prevented the asset-price bubble in housing?

Jerry L. Jordan, former president of the Federal Reserve Bank of Cleveland, launched the conference with his keynote address on the need to limit Fed discretion and adopt a monetary constitution. Criticizing the Fed's handling of the financial crisis, he noted that, "once you damage the underlying rule of law in the economic political system, it's very hard to restore." He went on to argue that "fiscal policies have become part of the problem. They are not part of the solution, and monetary policies cannot correct the mistakes made by the rest of government."

On the first panel, Carmen M. Reinhart, coauthor (with Kenneth Rogoff) of *This Time Is Different: Eight Centuries of Financial Folly*, argued that the primary problem facing U.S. policymakers is the large debt overhang. While asset prices should be watched, debt crises must be resolved; tough choices must be made. Adam Posen, an external member of the monetary policy committee at the Bank of England, cautioned that central bankers don't have sufficient information to target asset prices and thus should not do so.

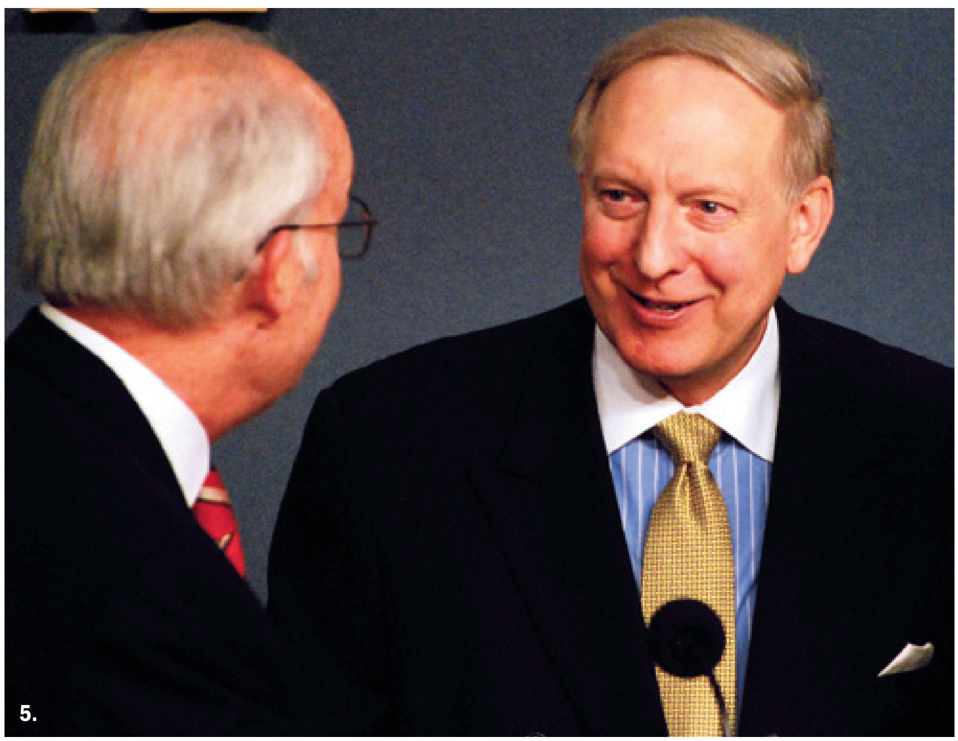
Lawrence H. White, Mercatus Professor of Economics at George Mason University, reminded everyone that the fundamental problem with the present global monetary

1.

2.

3.

4.



5.

1. JERRY L. JORDAN, former president of the Cleveland Federal Reserve Bank, discusses the Fed's unwarranted discretion. **2. GEORGE TAVLAS**, director general of the Bank of Greece, offered the experience of his own country as a warning to the United States, and stressed the need for a sound monetary anchor. **3. ADAM S. POSEN**, external member of the Monetary Policy Committee at the Bank of England, discussed monetary policy's impact on bubbles. **4. MICKEY LEVY** (left), chief economist of the Bank of America, talks with **JOHN B. TAYLOR**, author of the "Taylor rule" for monetary policy. **5.** Cato Institute vice president **JAMES A. DORN** (right), who has organized all 28 Annual Monetary Conferences, talks with Cato senior fellow **GERALD P. O'DRISCOLL, JR.**

regime is that it is a pure fiat money regime with no automatic adjustment mechanism. If there were a real gold standard and free (competitive) banking, sound money would have precluded the 2008–2009 financial crisis and would help prevent future crises.

George S. Tavlas, director general of the Bank of Greece, said he "felt right at home in the United States." He reiterated the point that there is no external constraint on the U.S. dollar as the world's key reserve currency. Any link to gold ended by the early 1970s. Without a sound monetary anchor, and therefore monetary discipline, the global monetary system is adrift. In the meantime, "floating exchange rates among all the major currencies would provide a mechanism for some adjustment to global imbalances and a safeguard against asset price bubbles and a future crisis."

Gerald P. O'Driscoll Jr., senior fellow at Cato and a former vice president at the Federal Reserve Bank of Dallas, placed most of the blame for the housing/financial crisis on loose monetary policy, but also pointed to other policy errors and nonmonetary real factors. Kevin Dowd, an economist at the Cass School of Business, London, agreed that monetary policy was the main culprit and warned that continued ultra-low interest rates and quantitative easing are fueling new asset bubbles in "Treasuries, financials, and junk." He favors getting rid of the Federal Reserve's "dual mandate" and having only one target: price stability. But, "a far better reform—and a far more appropriate one, given the Fed's dismal record since its founding—would be to abolish the Federal Reserve altogether and re-anchor the dollar to a sound commodity standard."

Other notable speakers included Charles Plosser, president of the Federal Reserve Bank of Philadelphia; John B. Taylor, professor of economics at Stanford University and author of the "Taylor rule" for monetary policy; and Manuel Sánchez, deputy governor of the Bank of Mexico.

The papers presented at the conference will be included in an upcoming issue of the *Cato Journal*. Video and audio of the conference is available at www.cato.org.

6. MANUEL SANCHEZ (left), deputy governor of the Bank of Mexico, talks with MARY ANASTASIA O'GRADY, editor of the *Wall Street Journal*'s "Americas" column, and IAN VÁSQUEZ, director of Cato's Center on Global Liberty and Prosperity. 7. In the front row at Cato's 28th Annual Monetary Conference: former Federal Reserve Bank presidents WILLIAM POOLE and JERRY L. JORDAN, MICKEY D. LEVY of Bank of America, and Cato senior fellow GERALD P. O'DRISCOLL, JR. 8. CARMEN REINHART, coauthor of *This Time Is Different: Eight Centuries of Financial Folly*, warns attendees that tough choices can't be avoided in resolving the debt crisis.