*Cato's 26th annual monetary conference more timely than ever*

# Economists Debate Roots of Financial Crisis







**1. Lawrence H. White blames cheap money and federal housing regulations. 2. Mary O'Grady of the *Wall Street Journal* asks a question, flanked by Otmar Issing, Jeffrey Lacker, Charles Calomiris, and Mickey Levy. 3. Conference organizer James A. Dorn welcomes Clive Crook of the *Financial Times.* 4. Jeffrey Miron of Harvard argues that failing institutions should be allowed to declare bankruptcy. 5. Brian Wesbury, John Makin, John L. Chapman, and Lawrence White. 6. Richmond Fed president Jeffrey Lacker argues that the new financial safety net must be rolled back.**

The question of what caused the U.S. financial crisis dominated discussion at the Cato Institute's 26th Annual Monetary Conference, "Lessons from the Subprime Crisis," held on November 19 in the F. A. Hayek Auditorium. That is, if you don't count debate over what ought to be done about it.

The specter of deflation haunted Donald L. Kohn, vice chairman of the Federal Reserve Board. Deflation is a sustained drop in the price level, considered problematic because it discourages consumption and investment as would-be buyers continuously wait for a better bargain. With the federal funds rate sitting at 1 percent, it would be difficult to stimulate new economic activity with further rate cuts, he contended. Still, given the ordeal of Japan in the 1990s, Kohn said the Fed "should be very aggressive with our monetary policy, as aggressive as we can be," should deflation seem to be setting in. Otmar Issing, former member of the European Central Bank's executive board, argued that central banks can help prevent asset bubbles by closely monitoring money and credit growth and maintaining long-run price stability.

Other panelists disagreed. Harvard University's Jeffrey Miron, echoing panelists ranging from Anna Schwartz to Cato's Gerald O'Driscoll Jr., countered that aggressive Fed rate cuts were what got us into this crisis in the first place. In particular, the Fed's easy money policies following the dot-com bust in 2001, combined with novel federal interventions in the mortgage market, led to overinvestment in that sector. New, underqualified home buyers entered the red hot market using government-encouraged subprime loans, counting on continued growth in home prices to remain in those homes. Investment banks holding mortgage-backed securities and mortgage-holding giants Fannie Mae and Freddie Mac had also banked on the continued growth in home prices, and when the housing bubble burst, all parties went under.

William Poole, senior fellow at the Cato Institute and a past president of the Federal Reserve Bank of St. Louis, said the private sector miscalculated just as badly as did the public sector, but he nonetheless urged current policymakers to end the arbitrary and ex post bailing out of failing firms during the current crisis. Such a policy has no intrinsic limit, with new firms lining up for assistance each day, and introduces additional moral hazard when there is plenty to go around already.

Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, stressed the need to reestablish boundaries between the public sector safety net provided by the Fed's new lending window and the market. Saying the newly established financial safety net must be "rolled back," he emphasized that in the current situation that would be a daunting task. Lawrence H. White of the University of Missouri, St. Louis, said such action must come soon, and called for a public debate on the wisdom of the Fed's "remarkable departure" from its traditional role.

Full video of the conference is available on Cato's website. Just visit www.cato.org/events/monconf2008/program.html. For *Cato Journal* subscribers, an edited version of the major policy addresses will be included in a future edition of *Cato Journal.*