From the limits of monetary policy to China's path toward capital freedom

Money, Markets, and Government: The Next 30 Years

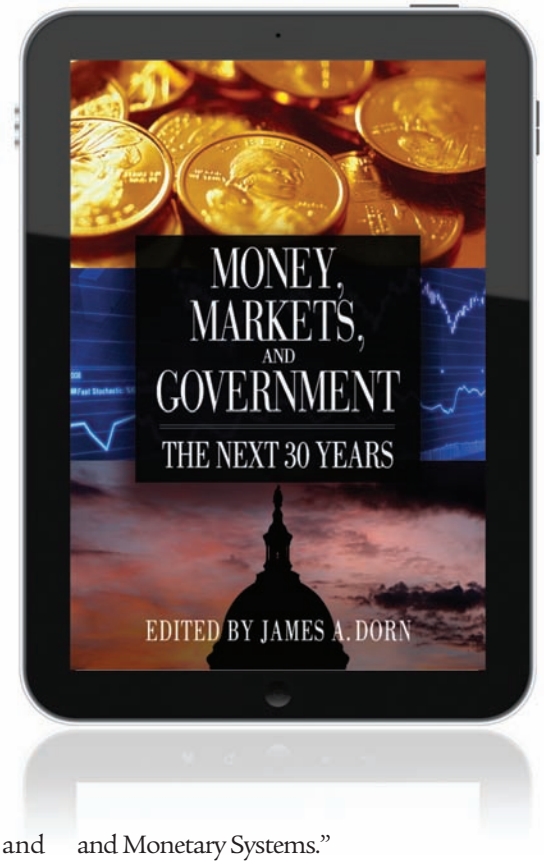
F. A. Hayek once wrote, "All those who wish to stop the drift toward increasing government control should concentrate their effort on monetary policy." It has become clear that the 2008–09 financial crisis and Great Recession have vastly increased the power and scope of the Federal Reserve. Ultra-low interest rates, quantitative easing, credit allocation, debt monetization, and new regulations have radically changed the monetary and financial landscape.

In *Money, Markets, and Government: The Next 30 Years*, a new Cato ebook based on the presentations from last year's 30th Annual Monetary Conference, various academics examine those changes and consider how the links between money, markets, and government may evolve in the future. "One path is to maintain a regime of discretionary government fiat money," editor James A. Dorn writes. "An alternative path is to limit the size and scope of government, adopt a rules-based monetary regime, and let free capital markets allocate credit." Ultimately, this choice will help determine whether economic and social harmony emerges spontaneously or government power continues to grow.

To avoid the next crisis, one must understand and draw lessons from the recent past. John B. Taylor, professor of economics at Stanford University, examines monetary policy during the past 30 years. He finds that during the 1980s and 90s, Fed policy was largely in line with the so-called Taylor Rule. Beginning in the early 2000s, however, the Fed turned to a strongly discretionary policy and held interest rates too low for too long, thus fueling the housing bubble. He argues in favor of a rules-based monetary regime.

Lessons can therefore be learned that improve monetary institutions, provided political barriers to real reform can be circumvented. Unfortunately, the politicization of money and banking has led to overreaching policies and a serious moral hazard problem, whereby financial institutions considered "too big to fail" act irresponsibly and take excessive risks. Allan H. Meltzer, Professor of Political Economy at Carnegie-Mellon University, is highly critical of the Fed's short-term perspective and, hence, the neglect of the medium- and longer-run consequences of expanding the Fed's "unrestricted power to do what it chooses."

Harris Dellas, professor of economics at the University of Bern, and George S. Tavlas, a member of the Monetary Policy Council of the Bank of Greece, go on to examine "the gold standard, the euro, and the origins of the Greek sovereign debt crisis." Unlike the classical gold standard, they note, the eurozone lacks a market-based feedback mechanism and has failed to enforce fiscal discipline. The expectation of a bailout therefore gave investors an incentive to hold Greek sovereign debt, in turn allowing Greece to live beyond its means. The lesson is that there must be a credible adjustment mechanism and sound fiscal arrangements to achieve long-run stability in the eurozone.



The rise of China as a global economy has been breathtaking. In 1976 China was a closed economy. Today it is the world's second largest economy, with a vibrant trade sector. As such, Eswar Prasad, the Tolani Senior Professor of Trade Policy at Cornell University, and Lei Ye, a graduate student in the department of economics at Cornell, examine the prospects for making the renminbi a global reserve currency. They emphasize that for China to fully internationalize its currency there must be free capital markets, a more flexible exchange rate, and financial market deepening. China is making progress in those areas, they conclude, but much remains to be done to eliminate financial repression.

Additional contributors to this volume include Steven Gjerstad and Vernon L. Smith on "Balance Sheet Crises," as well as Lawrence H. White on "Antifragile Banking and Monetary Systems."

The articles in this ebook, as well as four book reviews, are also featured in the latest issue of the *Cato Journal*. Available online at www.cato.org, that issue is dedicated to the late economic historian Anna Jacobson Schwartz.

The Cato Institute's first monetary conference in 1983, "The Search for Stable Money," sought to extend the debate over alternatives to discretionary government fiat money by including alternatives consistent with limited government, the rule of law, and free markets. Since that time, Cato has gained an international reputation for its scholarly work on alternative monetary regimes. With the 100th anniversary of the Federal Reserve, it is essential to continue to scrutinize the Fed, learn from its history, and understand how the invisible hand of competition can work to bring about a better future. ■

***Money, Markets, and Government* is available at www.cato.org/store, Amazon, Apple iTunes, and other online ebook vendors; $3.99.**