

Balancing Financial Stability, Price Stability, and Macroeconomic Stability: How Important Is Moral Hazard?

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There are two ways to view the question that comprises the title for this panel discussion. One concerns the *potential* for moral hazard issues to decrease stability. The other is the extent to which, currently, the issue in *actuality* has decreased stability or raised a problem for the Federal Reserve. The potential is clearly enormous. However, I believe that in the macroeconomic policy sphere, actual moral hazard problems today are relatively minor with the exception of a small number of large financial institutions whose managements and investors believe they can count on government assistance should these firms find themselves in deep trouble.

Before continuing, and although I have attended my last FOMC meeting, I need to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, but I retain full responsibility for errors.

MORAL HAZARD IN MONETARY POLICY

I addressed moral hazard in monetary policy in a speech at the Cato Institute last November, “Market Bailouts and the ‘Fed Put.’”¹ Let me repeat the gist of that argument.

The concept of moral hazard is most easily explained in the context of insurance. The very existence of insurance may change the behavior of the insured person, who becomes less careful in taking care of insured property than he otherwise would if the property were uninsured. Being less careful with others’ property than your own is not moral behavior and is a hazard to the insurance company.

Some claim that Federal Reserve policy responses to financial market developments should be regarded as “bailing out” market participants and creating moral hazard by doing so. In my view, this argument is incorrect because there is a benefit rather than a hazard to sound monetary policy that stabilizes the economy.

Consider a monetary policy that maintains low and stable inflation. If market participants have confidence in the continued success of that policy, then they need not structure their activities to be robust against a serious outbreak of inflation. Monetary policy does change behavior, but it is not a hazard to the economy that firms and households make their plans on the assumption of continuing price stability. Indeed, one of the arguments for price level stability is *precisely* that markets will work better and private decisions will be more efficient than in an environment of price level instability. Outcomes are more efficient because behavior changes in response to the environment of price level stability.

¹ http://www.stlouisfed.org/news/speeches/2007/11_30_07.html.

The same argument holds for monetary policy actions that serve to stabilize financial markets in the face of market turmoil of the sort that broke out last August. A monetary policy response to market turmoil is an application to modern financial markets of the traditional function of the central bank as a lender of last resort to the banking system. A belief that Federal Reserve policy actions will serve to stabilize the financial system will affect behavior, but not on the whole in a hazardous way. This validity of this assertion is less obvious than the case for price level stability; I will argue the case.

When financial markets are generally stable, many firms will decide that they can get along with less capital. All else equal, higher leverage obviously increases risk. Should there be a shock, a firm with less capital is more likely to have difficulty. However, in the more stable financial environment, shocks are less common and less severe when they do occur. If that were not the case, we would not describe the situation as being “a more stable financial environment.”

However, whatever the degree of financial stability, nothing protects an individual firm from its mistakes. The Fed’s actions in recent months have not prevented many financial firms from having to write down the value of billions of dollars’ worth of assets. Fed actions have been successful in helping to protect the financial *system* without protecting any particular firm. A number of hedge funds and mortgage brokers have gone under without a finger of public support being lifted to save them. That is as it should be.

Lenders have foreclosed on thousands of homeowners in default on their mortgages and have forced the former owners to leave their homes. So far, we have not seen significant government funds being supplied to prevent foreclosures, although proposals for such support are common. The public debate on this issue seems pretty healthy to me. People understand the anguish of foreclosure but also the potential moral hazard from bailing out homeowners who took out mortgages they could not afford or from bailing

out investors who made loans they should not have made. There is also a widespread belief among homeowners who are meeting their financial obligations that it would be unfair for the government to bail out “irresponsible” borrowers when responsible ones, perhaps with considerable struggle, are meeting their obligations.

As an aside, it seems to me that most of those advocating some sort of government action are supporting relatively narrowly drawn proposals that do not apply to investor-owned houses and to properties already in foreclosure. Whether or not a sound proposal can be enacted that avoids creating moral hazard remains to be seen, but current public debate is sensitive to the issue.

TOO BIG TO FAIL

In the context of macroeconomic stability, the main moral hazard issue arises in the context of “too big to fail.” I believe that it was Alan Greenspan who put the issue this way: No firm should be too big to fail but some may be too big to liquidate quickly. Suppose a large firm gets into trouble and the potential adverse consequences for stability are so great that intervention is unavoidable. In that situation, any intervention ought to take a form such that the costs to shareholders and management are so large that no firm in the future will want to allow itself to fall into such a situation. Lest I be regarded as a soft touch when I say that a situation could arise that could make intervention “inevitable,” I would set a very high bar to any intervention. Here is what I think is sound advice: “Experience suggests that the path of wisdom is to use monetary policy explicitly to offset other disturbances only when they offer a ‘clear and present danger.’” Some may be surprised to learn that the author of this sentence was Milton Friedman in his presidential address to the American Economic Association in 1967.²

In recent months, some boards of directors have forced out their CEOs and companies have

² *The American Economic Review*, March 1968, 58, p. 14.

raised new capital, diluting the ownership position of existing shareholders. I am sure that these costs will not be lost on future managements, but it remains to be seen how long recent pain remains in managers' memories. In any event, we are fortunate that in the current episode, so far anyway, no large financial firms have been so weakened by large losses that they were unable to raise new capital.

We have known for many years that moral hazard is a potentially serious issue. If a firm believes that it will be bailed out if it gets into trouble, that expectation encourages excessive risk-taking and increases the probability of trouble. There are two complementary ways to deal with moral hazard. First, firms in trouble ought not to be bailed out, unless the bailout takes a form that imposes heavy costs on managers and shareholders. Second, firms subject to government regulation ought to be compelled to maintain adequate capital to reduce the probability of failure. U.S. banks entered the period of turmoil last year pretty well capitalized and have been able to withstand large losses.

I am more skeptical of the financial strength of the GSEs, and believe that we could see substantial problems in that sector. According to the S&P Case-Shiller home value data released earlier this week, as of December 2007 average prices had declined by 15 percent or more over the past 12 months in Phoenix, San Diego, Miami and Las Vegas. We can add Detroit to the danger list as the home price index for that city is down by almost 19 percent over the 24 months ending December 2007. With house prices falling significantly in a number of large markets, many prime mortgages issued a few years ago with a loan-to-value ratio of 80 percent may now have relatively little homeowner equity, which increases the probability of default and amount of loss in event of default.

As I emphasized some time ago, GSE losses will depend on the variance as well as the mean of changes in national home prices. Losses in markets with home prices falling more than the national average will not be offset by gains in markets with price changes above the national

average. I do not have a new message here; we have known for a long time that advance preparation and a strong balance sheet are the keys to riding out a financial storm. As I have emphasized before, the Federal Reserve can deal with liquidity pressures but cannot deal with solvency issues. I do not have any information on the GSEs that the market does not also have. Nevertheless, in assessing the risk of further credit disruptions this year, I would put the GSEs at the top of my list of sources of potentially serious problems. If those problems were realized, they would be a direct result of moral hazard inherent in the current structure of the GSEs.

MORAL HAZARD RISKS TO ECONOMIC STABILITY

The title of this session starts with the word "balancing." Monetary policy is a balancing act, with dangers of recession and inflation both very real. My view, oft stated, is that the FOMC should give primacy to the inflation objective, because, if inflation develops while the FOMC is concentrating on avoiding recession, the consequence will be to delay recession but not to avoid it. And, most likely, the delayed recession in an environment of rising inflation and rising inflation expectations will be worse than the mild recession avoided in the immediate future.

The FOMC's "prime concern," though, must not be confused with "exclusive concern." The FOMC has good reason to respond to employment problems and doing so need not be inconsistent with maintaining an environment of price stability. Of course, different observers have different views as to whether the FOMC is striking the right balance, but the need to strike the balance ought not to be at issue.

The traditional monetary policy problem of balancing inflation and employment risks is seriously complicated when an event raising a moral hazard problem intervenes. When an event occurs risking extreme financial instability, the best course of action is probably for policymakers to keep the ship afloat and worry about the com-

pass course later. However, when bailing out a firm to keep the ship afloat, the aim should be to allow as much pain as possible to flow through to management and investors to discourage future risky behavior. To avoid a future inflation problem, monetary policy accommodation, which may be a part of the policy response, should be reversed promptly when the markets settle down.

Since World War II, the number of financial upsets is so few that we do not have a large sample from which we can draw lessons as to better and worse ways of handling the aftermath of financial turmoil. With the benefit of hindsight—and the importance of the word “hindsight” should be emphasized—it is not hard to argue that the FOMC was too slow to raise the federal funds target after taking the target down to 1 percent in 2003. I also believe that, with hindsight, the FOMC was too slow to start raising the fed funds target in 1999 after dropping it by 75 basis points to deal with the turmoil created by Long Term Capital Management. The problem in these episodes, however, was not related to moral hazard but to policy judgments of the usual sort of trying to strike the right balance between inflation and unemployment concerns.

THE CURRENT EPISODE OF FINANCIAL TURMOIL

We are currently living through an episode that will provide considerable evidence on several important questions. In five years or so, we will see whether the FOMC withdrew cuts in the fed funds rate target on an appropriate schedule.

The current episode will also provide evidence on a vexing issue of causation. As Greenlaw et al. emphasize in their very interesting paper, the relation of finance to the real economy has long been a puzzle because of the difficulty of sorting out cause and effect. There is a large literature on this issue. One tradition flows from Friedman-Schwartz, and, before them, the work of Irving Fisher, relating fluctuations in money growth to the business cycle. Greenlaw et al. report evidence on the relation of growth in domestic non-financial debt to growth in real GDP.

Although there have been a number of interesting efforts, no one has come up with a really convincing model of why fluctuations in nominal magnitudes should cause fluctuations in real magnitudes. A contrary view, also with an extensive literature, flows from work on real business cycles. From this perspective, the business cycle is a real phenomenon and nominal magnitudes are along for the ride. In the real business cycle model, causation runs from the business cycle to nominal financial magnitudes.

My own work has been within the Friedman-Schwartz tradition. I do not have any doubt that monetary policy mistakes can create recession. In trying to sort out the causality between money and output, Friedman emphasized the importance of evidence from natural experiments. I think it useful to think about that same approach in analyzing the current situation in the credit markets. We are dealing with something close to a natural experiment because the turmoil spreading from the subprime mortgage market was clearly unanticipated and, for the economy outside housing, basically exogenous and not closely related to changes in monetary policy. We are living through an episode that is as close as we have seen to a pure credit disturbance without an accompanying monetary disturbance.

Let me develop this theme a bit more carefully. The FOMC did, of course, raise the target federal funds rate from 1 percent in mid-2004 to 5.25 percent in mid-2006. The effect of rising interest rates in slowing mortgage finance was not a surprise; nor was a slowing in home price appreciation a surprise. In the quarters before August 2007, we did not observe a marked decline in money growth or any of the other usual symptoms of a monetary disturbance.

The growing scale of defaults of subprime mortgages in the spring and summer of 2007 was a surprise. I think it reasonable to regard the effects of these defaults on credit markets beyond the mortgage market as an exogenous credit disturbance—perhaps as exogenous as we get in our discipline. The issue at hand is whether this disturbance will cause a significant contraction in economic activity outside housing.

I focus on activity outside housing because it is obvious that this particular sector is overbuilt. The U.S. economy has experienced problems in particular sectors before, such as steel and agriculture in early 1980s. Those problems lingered after recovery from the 1981-82 recession began but did not prevent the recovery.

Weakness in investment in residential structures has been holding down GDP growth in a significant manner since the second quarter of 2006 but, through the last quarter of 2007, was not sufficient to push growth of GDP excluding housing below 1.5 percent. The issue is whether the credit market problems will have a significant adverse impact outside housing. By way of comparison, the shock of 9/11 had a quick and large impact; firms shed one million jobs in October, November and December of 2001. We have not yet seen an effect of credit turmoil on real activity of this magnitude.

CONCLUDING REMARKS

I suspect that the origin of this panel topic was the view that a central bank response to market turmoil creates moral hazard. A generalized monetary policy response, in the form of the FOMC cutting the target federal funds rate, is completely unlike the effects of government flood

insurance on homeowners. Flood insurance will compensate the homeowner, period. A monetary policy response may or may not occur at a time when a financial firm gets into trouble and may or may not be adequate to prevent a firm from failing.

Moreover, a financial firm cannot expect targeted aid for just the firms in trouble. An exception to this general statement is that, unfortunately, the GSEs probably can expect targeted aid. Thus, putting the GSEs aside because they might get assistance directly from Congress, expectation of a monetary policy response to financial turmoil is completely unlike the situation faced by the homeowner with underpriced flood insurance. Many homeowners do build houses in areas where they would not build if they were totally responsible for losses, or had to buy insurance in a competitive market. Financial firms, on the other hand, cannot expect aid if they build on the financial flood plain. And that is as it should be.

NOTE

Because this is a panel discussion, this text should be regarded as preliminary; I may add some comments reflecting earlier discussion at the forum.