Economists' forum

« Why obstacles to a deal on climate are mountainous
A year of living dangerously for the world »

July 14, 2008

by FT

Moral hazard misconception

by Ricardo Caballero

Here we go again. Two pillars of the US and world financial system, Fannie Mae and Freddie Mac, have become embroiled in the current financial turmoil. To be sure, nobody in their right mind expects these institutions to stop operating; the issue instead is whether, how and when a government intervention takes place.

Treasury secretary Henry Paulson has just announced a first package of all out support that involves contingent credit and possibly equity. The terms of the latter are yet unclear but they harbor hope that Treasury has realized how dangerous its previous anti-stockholders strategy had become. Only last Friday the rumor had it that Secretary Paulson was insisting that any potential government rescue plan would not benefit the companies' shareholders. In fact, if he were to continue with the *modus operandi* he adopted during the recent Bear Stearns intervention, not only shareholders would not benefit, but they would be "exemplarily" punished.

The standard rationale for such strategy is that doing otherwise would invite "moral hazard." That is, it would encourage excessive risk taking by equity holders as they can count with government insurance for their errors and mishaps. A slightly more cynical interpretation is that a bailout carries a political cost by giving the appearance of favoring the rich over the working families struggling with foreclosures.

Unfortunately, while either of these motivations is a sound one during normal times, Secretary Paulson's anti-"moral hazard" strategy has been extremely counterproductive in the current economic environment of systemic distress and recurrent flight-to-quality episodes. This policy simultaneously hampers the private sector's ability to solve the crisis and exacerbates the likelihood of further panics. There are two reasons for this backfiring.

First, a private sector solution to the current crisis requires fresh capital injections into financial institutions. However, in an environment of widespread uncertainty where the instinctive reaction is to run away from risk-taking, private capital is likely to remain on the side for much too long. Thus, the optimal policy response is to encourage and leverage private risk-taking, not to discourage it with a pending threat of exemplary punishment were a fragile situation turn worse, regardless of cause. Economic policy risk is compounding the private sector's reluctance to capitalize financial institutions.

Financial institutions and leveraged institutions more generally, are subject to coordination failures whereby a sudden loss of confidence can cause the demise of an otherwise sound institution. Granted, better managed and capitalized institutions are less likely to encounter a run - it is not a surprise that it was Bear and Stearns rather than JP Morgan that went under a few weeks back - but no institution is immune to panics, as long as it is providing its socially useful liquidity transformation and intermediation role. It has always been understood that it is good economic policy to help financial institutions ride crises of this kind, and that a central role of policymakers in such events is to stabilize expectations with the hope that once the panic is gone, it is private rather than public funds that foster the recovery. In fact, it is this perspective that led both the FED and the Treasury to support Bear Stearns on the days preceding the weekend's forced fire sale. By punishing equity holders, the Treasury chose to hurt those that it had invited to stabilize the situation just a few hours earlier. In doing so, it may have damaged its ability to leverage its policies with private capital support, a key aspect of policy success in dealing with a coordination failure problem.

Second, during periods of high uncertainty and the potential for runs, large or coordinated shortsellers are more likely to succeed in triggering socially inefficient panic-selling. Rumor-mongering and persistent selling pressure eventually weaken wary investors and depositors. Unfortunately, by choosing to punish shareholders, Secretary Paulson has rewarded shortsellers and raised their ammunition to cause further financial instability. Again, while shortselling plays a very useful role during normal times, it can turn into a source of instability during periods of high uncertainty.

In summary, given the extreme fragility of the current economic scenario, there is no doubt that it is better to err on the side of inducing "moral hazard" than to risk discouraging private capital markets initiatives and eliciting speculative attacks and wasteful predatory behavior. Failing to assess the relative risks correctly and obsessing over "moral hazard" at this time, carries the great danger that the financial system may succumb to a much more serious flight-to-quality problem.

July 14th, 2008 in Central banks, Credit squeeze | Permalink