The Case for Policy Sustainability

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Should we worry about moral hazard while the house is burning? The discussion about economic policy is full of biblical metaphors, the language of water and floods, and of fire extinction during crises. Metaphors, even when not mixed, are often obstacles to the clarity of thought. That is clearly the case with the metaphor of moral hazard in trying to understand the current financial crisis. Instead of focusing on moral hazard, I prefer to use the concept of policy sustainability to argue that sustainable monetary, fiscal, and regulatory policies are essential for lasting prosperity.

Moral Hazard: A Bad Metaphor

Moral hazard is a metaphor, an expression derived from the economics of insurance. In that context, however, it has a precise meaning: it refers to a situation that arises when an insured agent acts irresponsibly to the detriment of others, as a direct result of being insured. The idea of moral hazard is certainly central to the economics of insurance, but the concept is not quite right when we try to describe the choice faced by financial regulators or monetary policymakers. Of course, we have heard hundreds of times the term "privatized gains and socialized losses," and it sounds both hazardous and immoral. But that catch phrase does not get us anywhere.

Moral hazard is a bad metaphor for this crisis because its precise meaning in the economics of insurance has no one-on-one correspondence to this situation. Of course, bankers behaved inappropriately.

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Who can deny this? But did they really all expect to get bailed out by their governments, in the way that an insurance fraudster expects to get compensated by his insurance? I do not believe that Bear Stearns executives ever thought it was possible that they had to crawl to the Fed one day for help. First of all, not all banks got bailed out. Lehman Brothers did not, nor did Wachovia. And second, moral hazard would imply that bank managers as a group should have acted in a conspiracy. Moral hazard would imply that they fully calculated the risks, and behaved accordingly. My impression was that they did not fully understand those risks, and followed the crowd. They certainly followed, and still follow, overoptimistic risk models.

Moral hazard does therefore not fully capture the problem, and it is best to discard this concept in this context altogether, and to apply the much more appropriate notion of *policy sustainability.* Moral hazard is of course unsustainable. If not counteracted, an insurance company would go bankrupt, and the moral hazard would stop at that point. Monetary policy cannot fight moral hazard, but it can strive to be sustainable, and so can financial regulation.

The Sustainability Principle

In this light I would rephrase our original question in the following terms: If we accept, as we probably all do, that monetary policy should be sustainable, do we accept temporary deviations from the sustainability principle in pursuit of some other pressing short-term goal? Or put another way: If we follow some monetary policy rule, should we abandon it in times of crisis to support financial stability and prevent recession?

My answer to both questions is No. The Federal Reserve's dual mandate makes it somewhat tempting to pursue a tradeoff, but monetary policy does not work that way in practice. Perhaps a more appropriate definition of any dual target (including the European Central Bank's de facto dual target) is to keep interest rates as low as possible subject to *some* measure of price stability under *some* forecasting probability. We can disagree on the appropriate choice of price stability measure and probability. And this is where our approaches differ. But these are differences of metric, not differences of principle.

What do we know about the current economic outlook for both inflation and growth? It is clear by now that the U.S. economy has entered into a recession. But even the most pessimistic forecaster does not forecast a 1930s style depression with a accumulated fall in GDP by one third. The downside expectation is for an average recession, longer and deeper than the last two, something close to what we had in the 1970s and 1980s.

In such a situation one would expect interest rates to fall as the economy weakens, but one would also expect them to retain some relationship with measures of present or future inflation. We can all scare ourselves about deflation, but there is as yet no evidence that this is likely to occur. And the chairman of the Fed himself remarked in a well-known paper, the nominal zero percent bound is not as restricting as most people seem to think (Bernanke, Reinhart, and Sack 2004). There is a lot the Fed can do to prevent falling prices, starting with the mass purchase of government securities. I personally do not believe that this downturn will give rise to deflation, but if I am wrong, there are the tools to fight it. In the meantime, however, the best policy is to keep interest rates at a level that is consistent with our assessment of inflationary expectations.

If interest rates were to go to zero, as Larry Meyers is now forecasting, there is a risk of a sharp increase in inflationary pressures when the economy recovers, at a time when the central bank will be under immense public pressure not to kill off the incipient boom. There is a risk of negative real interest rates for a very long time to come, which is itself a very disturbing statement about an economy—and clearly not sustainable.

I also question the effectiveness of low policy rates in the present set of circumstances in terms of their ability to stimulate lending. Borrowers are currently constrained by the availability of credit and relatively high money market rates. Low policy rates constitute an inefficient and inequitable resource transfer to the banking system. But the ability of monetary policy to stimulate the economy is constrained.

This leaves the question: How can we effectively deal with the two interconnected dangers we are all so afraid of, a contagious collapse of parts of the financial system and a deep recession or a depression? Space does not permit a full analysis of the ongoing financial stabilization programs, but I believe that forced government recapitalization is the way to go. Of course, we cannot recapitalize all of the banks. We must also shrink an overblown financial system.

As for the real economy, the best stabilization tool available now is fiscal policy. But this tool, too, has to be used in a judicious and targeted way. In the United States, a more sustainable position for the economy would imply a lower current account deficit, and a higher private-sector savings rate. That combination is inconsistent with a continuation of the boom we saw in the preceding 10 years. To achieve sustainable economic growth, the United States will undergo an adjustment as part of which the economy will grow at substantially lower rates for several years. Fiscal policy should certainly try to prevent dangerous feedback loops, and to mitigate overshooting of house prices (but not to prevent price adjustment, which is necessary). But it should not prevent the necessary adjustments. Combined fiscal stimuli on the order of $1 trillion would in my view constitute a disproportionate response.

Conclusion

We need to think a lot harder about sustainability in the future. This is not a concept we should leave to ecologists. Nor is it something you do in good times, and abandon while in search of a cool metaphor.

Reference

Bernanke, B. S.; Reinhart, V. R.; and Sack, B. P. (2004) "Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment." Federal Reserve Staff Working Paper, No. 2004–48.