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Beware moral hazard fundamentalists

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Central to every policy discussion in response to a financial crisis or the prospect of a crisis is the concept of moral hazard. Unfortunately, there is great confusion in many quarters about the circumstances when moral hazard is, and is not, a problem. The world has at least as much to fear from a moral hazard fundamentalism that precludes actions that would enhance confidence and stability as it does from moral hazard itself.

The term "moral hazard" originally comes from the area of insurance. It refers to the prospect that insurance will distort behaviour, for example when holders of fire insurance take less precaution with respect to avoiding fire or when holders of health insurance use more healthcare than they would if they were not insured.

In the financial arena the spectre of moral hazard is invoked to oppose policies that reduce the losses of financial institutions that have made bad decisions. In particular, it is used to caution against creating an expectation that there will be future "bail-outs".

Moral hazard forms the basis for criticism of a wide range of measures including, among others; large International Monetary Fund loans to countries experiencing financial panics; public sector actions to facilitate co-ordination of creditors, as in the famous 1998 case of the New York Fed and Long Term Capital Management; lender of last resort activities by central banks through their discount window; aggressive cuts in interest rates following collapses in asset prices; and the extension of government guarantees or quasi-guarantees to liabilities of financial institutions, as in deposit insurance or the US government's support for the credit of mortgage lenders Fannie Mae and Freddie Mac.

Moral hazard fundamentalists misunderstand the insurance analogy, fail to recognise the special features of public actions to maintain confidence in the financial sector and conflate what are in fact quite different policy issues. As a consequence, their proposed policies, if followed, would reduce the efficiency of the financial sector in normal times, exacerbate financial crises and increase economic instability. They are wrong in three crucial respects.

First, granting for the moment the relevance of the insurance analogy, as the economist Michael Mussa has pointed out, the prospect that people may smoke in bed is not usually taken as an argument against the existence of fire departments. Moreover, if there is "contagion" as fires can spread from one building to the next, the argument for not leaving things to the free market is greatly strengthened. In the presence of contagion there is every reason to expect that individual institutions will under-insure because they will not feel obliged to take account of the benefits their insurance will have for others.

Second, the insurance analogy fails to take account of what is a key aspect of the financial context – moral hazard and confidence are opposite sides of the same coin. Financial institutions can fail because they become insolvent, as misguided lending or borrowing causes their liabilities to exceed their assets. But solvent institutions can also fail because of illiquidity simply because creditors rush to withdraw their funds and assets cannot be liquidated fast enough. In this latter case the availability of external support averts needless panic and contagion.

More subtly, but no less important, the knowledge that efforts will be made to stand behind solvent institutions facing runs reduces the capital institutions have to hold, encourages investment in productive but illiquid projects and reduces the risk of contagion.

Third, in the insurance template used in thinking about moral hazard, the insurer pays more out because of the behavioural changes induced by insurance, such as when the failure to install fire extinguishers makes fires more costly. Something parallel happens when the government guarantees a financial institution's liabilities.

But much of what financial authorities do in response to crises does not impose any costs on taxpayers and may actually make them better off. In the much criticised LTCM case no taxpayer money, except perhaps the cost of a lunch, was spent. A competent lender of last resort – in Bagehot's sense of one who lends freely at a penalty rate against good collateral – actually turns a profit, as the IMF did in its response to the financial crises of the 1990s. Monetary policies that prevent deflation of the kind that cost Japan a decade of growth in the 1990s are another example of how a policy can respond to stress without imposing costs on taxpayers or the economy.

Where does all of this leave policy? It certainly suggests that moral hazard is not always a negative with respect to policy responses to financial stress. In particular, the idea put forward by some that a central bank should act only once it is clear that financial problems have become serious enough to threaten a breakdown of the financial system or a sharp downturn in economic activity cannot be right.

Instead, these considerations suggest that prudent central banks will make judgments during financial crises not on the basis of "avoiding moral hazard" but rather by asking themselves three questions.

First, are there substantial contagion effects? Second, is the problem a liquidity problem where a contribution to stability can be provided with high probability or does it involve problems of solvency? Third, is it reasonable to expect that the action in question will not impose costs on taxpayers? If the answers to all three questions are affirmative, there is a strong case for public action.