

Chapter 14 – Crisis Policy: Balancing Risks

In the midst of a financial crisis, policymakers naturally wish to restore stability as quickly as possible (core principle 5). In fact, the U.S. Federal Reserve was originally designed as a crisis-management agency. Chapter 14 highlights, for example, the Fed's authority as *lender of last resort* to provide liquidity in a crisis.

However, government authorities know that some quick-fix policies create bad incentives and foster behavior that can lead to future disruptions. Such *moral hazards* are the key pitfall of crisis management policy and remain the most difficult challenge facing modern central bankers and financial regulators.

During a crisis, policymakers must balance the often-conflicting goals of crisis *mitigation* and crisis *prevention*. Frequently, there are no good choices. Like an emergency room doctor trying to save a dying patient, a policymaker must occasionally act to rescue the financial system from urgent threats and hope that any resulting problems the treatment creates can be addressed later. There are times when authorities will be forced to choose between accepting financial disruptions today and preventing an even larger threat tomorrow. To make an informed choice between these unpleasant alternatives, policymakers must try to anticipate and weigh the future, unintended consequences of their crisis-related actions.

As an example of a policy-induced moral hazard, consider the challenge policymakers face when deciding whether to *bail out* (protect) the creditors who own the bonds issued by a failing intermediary. In a usual bankruptcy, creditors take a *haircut*; that is, they take a loss, recovering only some fraction of what they were owed. However, haircuts that would be associated with the failure of a large, interconnected intermediary could lead to a catastrophic cascade of bankruptcies.

Now think about what happens in the event of a bailout. The bailout creates the expectation that the government will protect the creditors of all similar institutions – intermediaries that are *too big to resolve* (TBTR) in a crisis (see the Chapter 13 module: Policy Response to Systemic Intermediaries). This means that investors will treat the debt issues by institutions that are TBTR as equivalent to government debt (or nearly so), so they need not charge a risk premium. Government protection undermines the market discipline that creditors can impose (recall the Chapter 14 section on Problems Created by the Government Safety Net). TBTR intermediaries effectively receive a taxpayer-subsidized license to create systemic risk, making the next crisis more likely. And, at the same time, the lack of government protection for small intermediaries puts them at a competitive disadvantage.

A problem very much like this one has arisen during the financial crisis of 2007-09, when governments guaranteed bank liabilities in an effort to shore up banks' access to funding. One example is the Federal Deposit Insurance Corporation's (FDIC) program of providing temporary guarantees for banks' new debt issues beginning in

October 2008. As in the case of deposit insurance, in order to prevent a run on the bank's debt, the FDIC promised a to make creditors whole in the event of failure.

While the FDIC program succeeded in its primary purpose of allowing large intermediaries to fund themselves in the market, it had some predictable side effects. Prime among them is that it undermined creditors' incentives to monitor bank behavior. The "cure" almost surely exaggerated another disease: the loss of discipline on bank risk-taking arising from deposit insurance (see Chapter 14 Applying the Concept: Does Deposit Insurance Really Work?). While deposit insurance has tamed bank deposit runs in the United States, it also has encouraged banks to take more risk.

Unintended consequences of policy actions can arise surprisingly quickly. For example, some observers suggest that the U.S. government's unprecedented March 2008 bailout of creditors to an investment bank – Bear Stearns – raised the chances of another crisis.¹ The government's actions encouraged the view that the creditors of other intermediaries like Bear would be similarly protected. This assessment may have led Lehman Brothers and similar intermediaries to postpone their search for private capital and for secure funding. Lehman's lack of preparation eventually exposed its creditors to enormous losses in September 2008, when its failure also set off the biggest systemic disruption since the Great Depression.

Going forward, central banks and regulators in many countries face the enormous challenge of trying to lower systemic risk in the financial world without diminishing the supply of financial services. Some portion of this systemic risk arises from regulators' own (possibly unavoidable) crisis management actions. One leading international financial institution recently articulated the new regulatory goals as: "Ensuring that the decentralized financial system operates safely and efficiently does not simply mean more regulation or more centralization; rather, it means better regulation and better supervision that induce the private sector to improve incentives, risk management and governance."²

¹ While this claim has some validity, the alternative policy option of imposing large haircuts on Bear's creditors had an even greater chance of disaster. Given the fragility of the financial system, policymakers had no attractive option when the run on Bear began.

² Bank for International Settlements, *Annual Report*, June 2009, page 117.