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Moral hazard at the Fed

Why this reluctance to intervene in the markets?

By Robert D. McTeer

You shouldn't ski in those remote mountains. What if there's an avalanche?

Don't worry. They always send in search and rescue teams if there's a problem.

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Why move to New Orleans? It's still below sea level and will flood again.

That's not my problem. The government is rebuilding the levees. You'll be paying more for me to live in the Big Easy than I will.

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I'm not sure they can handle this mortgage after the rate adjusts, but that's somebody else's problem. I'm selling it as soon as they sign.

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If you don't clean your room, you won't get any dessert tonight. You know the rules.

Oh, well, just this one time. But from now on you definitely won't be getting dessert until you've cleaned your room.

Moral hazard, illustrated above, is another one of those things that's easier to recognize than to define. My definition is, when the cost of an action is borne by someone else or when mitigating the consequences of bad behavior encourages such behavior in the future.

The Fed's reluctance to intervene in financial markets began as fear of inflation but soon became fear of moral hazard. The Fed didn't bail out the Long Term Capital hedge fund in 1998, but it's still haunted by the myth that it did.

The Fed increased its target federal funds rate from 1 percent in June 2004, when I was still there, to 5.25 percent just over two years later, where it has remained for more than a year. Yet long-term interest rates hardly budged – the "conundrum" – and progress against creeping inflation has been limited. Despite a slowing economy pulled down by a decline in housing, the Federal Open Market Committee has continued to regard inflation as a greater danger than the weakening economy and has

held tenaciously to its inflation "bias." However, as Billy Joe Shaver might put it, they stayed too long at the fair.

While an inflation bias doesn't preclude easing, it does make it awkward. That's why I had hoped the FOMC would change its bias to neutral at its Aug. 7 meeting. Instead, the committee retained it:

"Although the downside risks to growth have increased somewhat, the committee's predominant policy concern remains the risk that inflation will fail to moderate as expected."

Many people found that statement incredulous in view of the growing turmoil in credit markets and its likely spillover into the real economy. After a brief pause, market turbulence worsened and, although its federal funds target remained unchanged at 5.25 percent, the Fed aggressively pumped reserves into the banking system. So much so that federal funds traded well below their target for several days.

Despite that "stealth" policy easing, the market clamored for something more formal. They got it when the Fed, in an unusual move, cut the discount rate by 50 basis points last Friday and liberalized collateral requirements.

The markets interpreted this action, and the accompanying statement, as a shift to an easing bias and expect a formal easing at the next committee meeting, Sept. 18, if not before. In a continued flight to quality, markets have driven short-term Treasuries well below the 5.25 target for

Fed funds. The committee reluctantly fed the alligator and will now have to feed it again, sinking deeper into the moral-hazard swamp.

The new chairman wanted to avoid a "Bernanke put," a perceived floor under the markets. He didn't want to bail out risky business or, in some cases, funny business. He rightly wanted to let market discipline work.

On the other hand, babies were being thrown out with the bath water. The markets were punishing the innocent along with the guilty and

leaving them for God to sort out. I think Ben Bernanke, my friend, did the right thing to resist, and he eventually did the right thing by relenting. Better to go easy on some of the guilty than to punish many of the innocent. But, next time – next time, for sure – the market is going to have to clean its room first.

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