# Responding to Economic Crises: Good Intentions, Bad Incentives, and Ugly Results

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The views expressed today are my own and not necessarily
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## Introduction

Thank you for that kind introduction and warm reception. It is indeed my pleasure to have this opportunity to be here with you today and share some thoughts about the economic crisis and its implications for our economy's future. It is all the more pleasant because I am proud to be a member of the Union League of Philadelphia and have come to appreciate its rich traditions that are so much a part of our region and our economy.

Today I would like to take a step back from the day-to-day debate about the economy and the recovery and focus on a bigger picture – the tension between our desire for economic stability and our desire for prosperity. Before continuing, I should note that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

We are gradually emerging from the depths of the recent economic crisis. While our economy has experienced recessions before and is likely to experience them again, the recent one has been unusual in its magnitude and its financial nature. In the wake of such a painful experience, it is natural for the public to look to policymakers and government for ways to prevent such a crisis in the future. Of course, lawmakers respond as might be expected. Just as carmakers make cars, lawmakers make laws. We now have a massive financial reform law that will generate many new regulations. Its goal is to substantially reduce the chances of another financial crisis and to lower the costs of financial disruptions when they do occur.

Of course, no reform is perfect. When the next crisis inevitably arises, the cycle will likely repeat itself, with more laws, more stringent regulations, and more assurances that – this

time – we have eliminated the possibility of bad economic outcomes and have prevented reckless behavior from disrupting the economy.

Why do such cycles occur? Because the public and our lawmakers seldom recognize that attempts to insure against bad economic outcomes can sometimes be counterproductive. New rules and regulations, often made with good intentions, can create bad incentives, which, in turn, yield ugly results. The ugly results could include another, but perhaps different, crisis or a reduction in the vibrant and dynamic growth of our economy. Our efforts to "fix" a perceived economic problem might create unintended consequences. I acknowledge that many other factors played a role in our recent crisis, including distorted incentives created by the rating agencies, mortgage brokers, and mortgage securitization markets. But today I want to concentrate on the incentives created by government policies.

**The Role of Markets and the Financial System**

Economic theory and practice tell us that markets serve the economy well by helping to allocate resources to their most productive uses. For example, when the relative price of some good or service is high, it signals a degree of scarcity or high value. Higher prices encourage individuals and businesses to allocate resources to increase production of that good or service, and they are rewarded for doing so efficiently.

Financial markets and intermediaries play an important role by efficiently pooling funds from savers and investors and allocating them to firms with potentially profitable projects and ideas. Most high-growth economies have well-developed financial systems, and a growing body of research suggests that development of the financial system leads to stronger economic growth (and is not merely an outcome of economic growth).[1]

Markets are also a mechanism for choosing winners and losers. Our country has achieved a high standard of living by rewarding entrepreneurs and businesses that take risks by creating innovative products and services. Of course, if it turns out that consumers or

[1] See Ross Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature* 35 (1997), pp. 688-726.

businesses don't want those products, then the producers will lose their investment and may even fail. For a market economy to function effectively, individuals and businesses must not only have the freedom to reap the rewards of their success, they must also have the freedom to fail. As my friend the economist Allan Meltzer has said, "Capitalism without failure is like religion without sin. It doesn't work."[2] Firms must be allowed to bear the brunt of bad decisions. When we see firms fail, we should not take that as an indication that the marketplace is failing us. Rather, we should take it as an indication that the market is doing what it is supposed to do, reducing inefficiencies and enhancing productivity.

This sorting out of winners and losers by the marketplace is key to our dynamic and productive economy. Innovation is inherently risky, so the returns for success must be high enough to compensate for the risk that businesses are assuming. Yet, simply taking on a risky project or investment is not a guarantee of success. Moreover, asking government to insure all manner of firms and individuals against bad economic outcomes or limiting all forms of risk-taking would be detrimental to innovation and economic growth. We might have less volatility and, perhaps, less inequality, but we would also have a lower standard of living.

**Government Policy and Incentives**

The financial crisis has led people from all walks of life – economists, policymakers, consumers, and business leaders – to ponder the future of our financial system and even the basic tenets of capitalism. Despite the rhetoric, the financial crisis was not a failure of our capitalist system. Nor was it largely the result of a lot of greedy evildoers whom we could just put in jail to solve the problem. Rather, it largely reflected a collection of incentives, some arising in private markets and some created by the government that motivated individuals to act in ways that proved damaging to the nation's overall economy.

People respond to incentives. And the incentives in our financial system led participants to act in ways that ultimately resulted in the financial crisis. But government policies, many of which were designed to control market outcomes or to achieve specific policy objectives, can,

[2] See Allan Meltzer, "Asian Problems and the IMF," *Cato Journal*, 17:3 (Winter 1998), pp. 267-74.

and do, affect incentives. The distortions caused by such policies can lead to bad outcomes, no matter how good the intentions.

As our recent crisis demonstrated, though, it is important to acknowledge that market failures happen, and these sometimes call for government intervention. The form of that intervention should alleviate the source of the market failure – we need to cure the disease and not just treat the symptoms. For example, suppose shareholders and creditors aren't able to obtain the information they need to assess the financial condition of a firm. An appropriate government response may be to require additional disclosures so that shareholders and creditors can exert market discipline to control and monitor the firm's risk- taking. Good regulation works to align incentives so that market discipline is strengthened. It encourages self-interested financial firms to act in ways that further our societal goal of a financial system that is less prone to crises while facilitating economic growth.

Unfortunately, there is a long history in which well-intentioned government policies and regulations distorted incentives rather than aligned them with overall economic well-being. For example, excessive leverage in many financial institutions exacerbated the financial crisis. Yet, our tax code encourages reliance on debt financing over equity financing by making interest payments tax deductible for the firm while dividend payments are not. Similarly, many observers lament the fact that American consumers have been living beyond their means with too much debt and not enough savings. However, our tax code has encouraged such behavior by allowing interest payments to be deducted while taxing capital gains and double taxing dividends, all of which discourage saving and investment and promote debt-financed consumption. Moreover, the tax deduction for mortgage interest skews the decision between being a homeowner and a renter.

Another example of distorted incentives arises in the decades leading up to the financial crisis and during the crisis itself, as the government expanded the safety net for financial firms and in so doing provided them with implicit and explicit subsidies. These types of guarantees, like those given to the creditors of firms deemed too big to fail and to Fannie Mae and Freddie Mac, undermine the natural forces of the market to limit excessive risk-taking. If a firm's

creditors know that they will be bailed out if a financial firm's risky bet doesn't pay off, what incentive do they have to monitor the firm and pull out their money if the firm takes on too much risk? What many see as market failures during the financial crisis were actually the result of poorly conceived regulations, which failed to recognize the distorted incentives they created.

**The Role of Regulation**

In perfectly competitive markets with all buyers and sellers having all the information they need to make informed decisions, firms acting in their own self-interest produce efficiently and informed creditors control risk-taking. Consumers benefit since they end up paying lower prices for goods and services. In such a world, incentives are aligned. Firms acting in their own self-interest also act in society's interest.

But we do not live in such a perfect world. Market imperfections exist and, in some cases, are significant enough to warrant some form of government intervention. For example, the depth and efficiency of the equity market depend on investors' confidence that all market participants have the same information and are competing on a level playing field. In response, the SEC bans insider trading so that individuals with information about the firm that is not publicly available are not able to take advantage of other investors.

Banks and other forms of financial intermediaries add value to the economy by bearing the risk inherent in borrowing short in the form of deposits and lending long. But this maturity transformation means that a bank can be undermined if many depositors decide to withdraw their funds in large quantities. If such runs on bank liquidity become sufficiently widespread, it can be very costly to the economy as a whole. Deposit insurance is a government intervention to protect depositors from loss, which mitigates the risk of bank runs. But this intervention has a cost associated with it – it reduces the incentives of depositors to monitor the risk-taking of their bank, thereby reducing market discipline. Bank supervision and regulation attempts to limit excessive risk-taking in banks supported by the safety net.

There is another similar, yet more subtle, set of rules and regulations that undermine market discipline and encourage a heavy reliance on short-term financing of long-term

investments. As I just mentioned, traditional banks typically fund their investments or loans with government-insured deposits and thus are more heavily regulated because of their access to the government safety net. Yet institutions such as investment banks also fund themselves with short-term debt, notably, repurchase agreements or repos and other swaps-like instruments whose maturities are typically overnight.

While these overnight loans to the investment banks are not explicitly guaranteed by the government, the bankruptcy code says that should the borrower get into financial distress and file for bankruptcy, these overnight, or very short-term, lenders can immediately receive their collateral and do not have to wait in line with other creditors. Thus, market discipline is undermined as these overnight lenders have little incentive to monitor the risk-taking of these institutions, since they will almost certainly get paid. This means that overnight funding was cheaper because creditors did not have to incorporate the risk of default. So the bankruptcy code effectively provided incentives for these nonbank financial institutions to borrow very short and lend long. When liquidity became scarce, this proved a debilitating strategy for these firms and contributed significantly to the financial crisis.

**Well-Designed Regulation Focuses on Aligning Incentives, Not Distorting Them**

Well-intentioned regulation must be well designed to get desired results. If regulation distorts incentives, it can create moral hazard problems whereby firms don't bear the costs they impose on others. Such regulations can have unintended consequences that interfere with achieving the regulations' goals.

A classic example of moral hazard is in insurance markets. If you have comprehensive insurance coverage on your car, you might drive more recklessly or not be as careful to lock your car. To help control this moral-hazard problem, many insurance contracts contain deductibles and copayments. Note that these insurance contract features were not mandated by government. They emerged as a market solution to the moral hazard problem. In many cases, market solutions are perfectly capable of controlling these types of moral-hazard problems.

Moral hazard problems are an inevitable outcome of the government safety net, as I illustrated in the case of deposit insurance. It has only been worsened by government rescues of large, complex financial firms that find themselves in financial distress. Financial firms that are considered too big to fail do not bear the full costs of the risks they take on. This is because their creditors – like depositors – believe they will be bailed out if the firm fails and so they have no incentive to monitor the firms' risk-taking. Market discipline breaks down because of the government's policy to bail out big banks rather than allowing them to fail. This is not a failure of markets; it is the response of market participants to policies and incentives created by government actions.

One key step in restoring market discipline is devising a credible resolution mechanism for large institutions. It needs to impose losses on creditors as well as shareholders and to do it in a consistent manner so that they have the incentive to take adequate precautions against failure.[3] The Dodd-Frank Wall Street Reform and Consumer Protection Act and the FDIC's recent proposed rule clarifying how creditor claims will be handled in a resolution regime are steps in the right direction toward taking away regulatory discretion in resolving large financial firm failures, but it remains to be seen if they are sufficient to resolve the too-big-to-fail problem.

Perhaps some of the most serious distortions that played out during the recent crisis were those caused by the government's policies toward housing, however well-intentioned. The U.S. government has long had a goal of increasing homeownership rates and established the GSEs (including Fannie Mae and Freddie Mac) in support of that goal. These institutions were privately owned, but as agencies of the Federal government, they enjoyed subsidized borrowing rates because the market believed they had an implicit government guarantee. Thus, market discipline was low, but the institutions were not heavily regulated either. So neither market forces nor government oversight imposed adequate controls and the institutions were not forced to bear the cost of the risks they took on. Because they were

[3] See Loretta J. Mester, "Regulatory Reform and the Role of the Fed," presentation at the Princeton Colloquium on Public and International Affairs: The "New Normal"? American Policy Making After the Great Recession," April 17, 2010.

allowed to be thinly capitalized and highly leveraged, it became very profitable for them to grow their portfolios – they became so large that the market believed they were too big to fail, which turned out to be true.

Fannie and Freddie were put into conservatorship on September 6, 2008, and I believe the costs of rescuing them will exceed that of any other financial institution that has received taxpayer support.[4] If, instead, the government had heeded the warnings of many economists in both the private and public sectors and had limited the size of the GSE portfolios and required them to hold more capital, the outcome would have been significantly different.

The costs of the government subsidies to Fannie and Freddie go beyond the direct cost to the taxpayer for their rescue. The fact that they had implicit government backing meant that ordinary banks found it hard to compete with them on conventional mortgages. Thus, banks found other ways to compete in the residential mortgage area by taking on more jumbo, sub-prime and alt-A mortgages than they otherwise would have – which exacerbated problems at commercial banks. It is unfortunate that financial reform has yet to address the problems created by these government created and sponsored entities.

**Instead of More Regulation, Better Regulation**

Instead of more regulation, we need better-designed regulation that recognizes incentives and tries to address moral hazard so that market discipline can work. Overly proscriptive regulation is counterproductive – it increases the incentives to evade it, which ultimately defeats it. Financial innovation spurred by the desire to evade regulation and relocating activities outside of regulation's reach are not productive, but they are an expected outcome if regulations are not well designed. Market discipline is an essential part of our market-based economy, and regulation should be designed to enhance it, not thwart it.

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[4] As of the end of August 2008, Fannie Mae's retained mortgage portfolio was $760 billion and its total mortgage book was $3 trillion. Freddie Mac's retained mortgage portfolio was $761 billion and its total mortgage book was $2.2 trillion.

This requires scaling back some of the safety net subsidies that have risen over the years and increasing capital requirements.  Implicit government guarantees to firms that are too big to fail and to housing finance agencies need to be reduced.  Having a way to resolve insolvent institutions without endangering the stability of the financial system is imperative.  In order to create market discipline, creditors must believe that they will bear some costs when firms fail. And they must have the tools to be able to evaluate the safety and soundness of firms to which they lend.  This means requiring more disclosures of information from the whole spectrum of financial firms:  if we expect stockholders, creditors, and counterparties to exert market discipline, we need to ensure that these participants have the necessary information on which to act.

**Conclusion**

Let me conclude by returning to where we started – the importance of markets in rewarding winners and punishing losers.  The goal of financial regulatory reform cannot be near-zero volatility and risk.  Financial firms are beneficial to economic growth precisely because they are willing to take risks and are leveraged institutions.  Regulation and supervision should foster financial stability, but eliminating all firm failures cannot be the goal. Government policies, no matter how well-intentioned, affect incentives and can undermine the working of market discipline if the policies are poorly designed.  By interfering with the market's ability to choose winners and losers, such policies are counterproductive and will weaken our innovative and productive economy in the long run.  This is something to bear in mind as we redesign our financial regulatory structure.  Perhaps there should more focus on eliminating distortions created by current legislation rather than simply adding more.