

MESSAGE FROM THE PRESIDENT



Jeffrey M. Lacker, President

For the past two years I have used this space to discuss the difficulties the economy has faced and the potential sources of those problems. To be sure, there are many people who are still hurting. Employees of this Bank—and members of its boards of directors and advisory councils—have learned a great deal as we have traveled throughout the Fifth District, listening to the obstacles facing people and businesses in communities from West Virginia and Maryland down to South Carolina. These problems are real and many will not have easy solutions. But I am pleased to be able to say that I think the economy, as a whole, has turned the corner and is now showing signs of growth. We are not out of the woods, but I think we are starting to see some light peering through the trees.

As the economy begins to recover, policymakers are naturally looking at ways to prevent future financial crises. Much of this discussion has been productive and has spawned some fruitful ideas. But in the wake of a crisis, there also is often a desire to reform something quickly, based on a presumption about what “must” have gone wrong, without sufficiently careful scrutiny. This year’s *Annual Report* essay, written by Kartik Athreya, a senior economist at the Richmond Fed, discusses one such idea: “systemic risk.”

What do policymakers and economists mean when they use the term systemic risk? Many different meanings have been put forth by many different people. Indeed, the lack of precision in defining systemic risk is itself an impediment to clear thinking about financial regulation. Many regulatory reform proposals would attempt to reduce the potential of systemic risk to harm the economy by providing regulators with additional tools to contain or manage such risks in the event of a crisis. But how can we accomplish that if we do not have a clear understanding of the phenomenon?

In his essay, Athreya identifies systemic risk with “linkages between market participants that lead to outcomes that can be unambiguously improved after a shock.” Note carefully the phrase “after a shock.” It highlights the fact that a policy intervention may appear useful when undertaken during a crisis (“ex post”), but could well be detrimental when evaluated before the fact (“ex ante”) because of the way it affects the incentives of financial market participants.

There are good reasons, as Athreya argues in his essay, to pursue ex-ante rather than ex-post efficiency. Does this mean, then, that we must throw up our hands and do nothing to ameliorate future shocks? No. But I don't think it will be sufficient to more tightly regulate firms regarded as systemically risky. In fact, this could actually increase the fragility of the financial system.

There are several reasons why financial institutions decided to take on what now appears to have been excessive risk. But the heart of the problem—as I have argued elsewhere—is that many firms believed they would not bear the full consequences of those decisions should they turn sour. The presence of the federal financial safety net altered their incentives in a way that reduced the cost of risk to them and their creditors. A fundamental lesson of economics is that when you make something cheaper, you are likely to get more of it, and we did. We need to tighten the limits around the safety net and make them transparent to everyone. And most importantly, our ex-post actions in a crisis must conform to our ex-ante commitment to forcing uninsured creditors to bear the full consequences of their actions.

If instead we were to deem some set of financial institutions systemically important, either explicitly or implicitly, it would be reasonable for the creditors of those firms to believe that should a problem arise, government help will follow. This would give large incumbent firms a permanent funding advantage and undermine competition from smaller rivals.

Robust competition is one reason the American economy has remained so resilient. As I said, I believe the economy is now recovering, despite having just been through a very deep recession. Nonetheless, the downturn is still affecting millions of Americans, and in such times it is natural to want to respond, to try to safeguard people from a similar event in the future. But we must act carefully, and that requires a prudent assessment of the causes of that adversity. My view is that such an assessment cautions against creating new tools for ex-post intervention, however immediately appealing that effort may sound. Fortunately, we possess some of the tools to help prevent financial shocks that generate calls for such intervention. Among them is the willingness to not assist uninsured financial institutions should they find

themselves in peril. Such commitment—if it can be made credible—would give firms and their creditors a strong incentive to manage more carefully the risks in their portfolios. Pledging to not intervene is a more difficult task than it may seem, as events have shown. But it is an effort well worth pursuing, for our economy and our citizenry.



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President