

Financial System Fragility — Inherent or Induced?

When I was a college student some years ago, I took a seminar class in the government department on international relations. One of the readings was Graham Allison's *Essence of Decision*, his account of decisionmaking within the Kennedy administration during the Cuban missile crisis. The book taught me a lesson that I hadn't received in my economics classes: In a crisis situation, when the available facts are evolving quickly and seem to point in more than one direction, policymakers tend to rely heavily on theory to help them make sense of those facts.

Flash forward to 2007-2008 and the financial turmoil that struck the United States during that period. I found myself among the regulators and policymakers who needed to interpret what was happening quickly and contribute to decisions about how to respond. Among the unknowns in mid-2007, before disaster struck: What firm conclusions, if any, should be drawn from the fact that mortgage delinquency rates have been rising steadily for over a year? And once the existence of a crisis becomes clear, what weight should be given to the benefits of minimizing financial distress today (for example, through bailouts of institutions) versus the costs of moral hazard that could promote further risk-taking tomorrow?

The transcripts of Federal Open Market Committee (FOMC) meetings during this time show participants looking closely at the facts that were available and seeking to resolve them into a coherent interpretation of what was happening. The same, surely, was taking place within the Treasury Department and elsewhere. As in other crises, moreover, the lens through which policymakers turned scattered and contradictory facts into interpretations, and ultimately into policy conclusions, was theory.

Without trying to survey the entire landscape of theories about financial markets, I would like to highlight two broad alternative views that influenced policymakers during and after the crisis. One sees financial markets as inherently prone to fragility. In this view, the inherent fragility of markets makes it necessary, in turn, for policymakers to create an expectation of a financial safety net to maintain the trust of market participants in institutions and to minimize destabilizing behavior. This view has led to a number of instances starting in the 1970s in which government has extended the financial safety net beyond the scope of deposit insurance. Among these is the private bailout of the hedge fund Long-Term Capital Management (LTCM) organized by the New York Fed in 1998; even though the LTCM rescue was privately financed, the Fed's involvement may well have changed expectations about the Fed's willingness to sit out a failure of a major financial firm.

The other broad view sees fragility in financial markets

as something induced in large measure by government policies themselves. This view recognizes that financial distress is always a possibility (because some losses and failures are inevitable), but it emphasizes the incentives of market participants to manage risk through their selection of institutions and contractual arrangements.

For example, bondholders can insist that an institution maintain an agreed level of equity to create a buffer against losses. In this view, expanding the financial safety net, either explicitly or implicitly, lessens the incentives of participants to adopt stability-enhancing arrangements — thereby rendering the system more fragile.

During the financial crisis, the model of inherent fragility predominated in shaping policy responses. Most notably, the Fed increasingly used emergency lending and, later, purchases of assets to encourage lending and to establish a safety net beneath large institutions.

It is not clear how much these measures contributed to stabilizing the U.S. financial system even in the short run. For those of us who see merit in the model of induced fragility, however, a greater concern is the longer-run effects of such programs. The actions taken by the Fed likely had the effect of telling the market to expect actions in support of large institutions if they fell into distress. The institutional leaders hearing this message would naturally feel less urgency in safeguarding their firms by, for example, raising capital or selling assets. There are indications that the leaders of Bear Stearns and Lehman Brothers had this point of view in the weeks leading up to their firms' failures in 2008.

Parts of the Dodd-Frank Act enacted after the crisis, including its rules for "living wills" to enable distressed financial firms to be wound down without government support, reflect the induced-fragility view. Yet the financial safety net is still large; it included as much as 57 percent of all financial firm liabilities at the end of 2011, up from 45 percent in 1999, according to research by my Richmond Fed colleagues. The persistence of the safety net and the moral hazard that goes with it means that the work of responding to the crisis is not yet finished. **EF**



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