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HAZARDOUS MATERIALS?

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In the course of the ongoing financial crisis, we've been ceaselessly reminded of the dangers of moral hazard—the idea that if people are insulated from the negative effects of their gambles they are more likely to act rashly. When Bear Stearns was bailed out, last spring, the move was attacked for exacerbating the threat of moral hazard. When Lehman Brothers was allowed to go bankrupt, in mid-September, the decision was praised by some for reducing the risk of moral hazard. These days, moral-hazard concerns are making policymakers cautious about stemming the rise in foreclosures, and about dealing with ailing banks: if we bail out banks or homeowners, we're told, it will only encourage more recklessness.

The concept of moral hazard seems commonsensical. A frequently cited example is fire insurance: people who know they'll be reimbursed if their house burns down supposedly won't worry as much about preventing fires, and so will have more fires than people who don't have insurance. By extension, the argument goes, if banks think that the government will bail them out in a pinch, they're more likely to make risky bets. That's why moral-hazard fundamentalists advocated letting Lehman Brothers fail, and making it clear that bad decisions have consequences.

Of course, not acting also has costs, and sometimes—as in the case of Lehman's failure—those costs are immense. So, if the threat of moral hazard is going to encourage inaction in a crisis, we should be sure that threat is real. And there certainly are situations where moral hazard does seem to have an effect on people's choices. Deposit insurance can make depositors less vigilant about the quality of banks, increasing the likelihood that bankers will make bad gambles with depositors' money, as they did during the savings-and-loan crisis of the eighties. In other circumstances, though, moral hazard seems to have a much smaller impact. And, in the case of public-sector

intervention during financial crises, evidence for its dangers is surprisingly flimsy.

The International Monetary Fund, for example, has helped bail out developing countries across the globe. If those bailouts heightened moral hazard, you'd expect the recipient countries to be more reckless in their spending and borrowing, and outside investors to be more careless in their lending. Yet a number of studies looking at the effects of I.M.F. bailouts on things like credit spreads and capital flows have found little evidence for that. On the contrary, a 2002 study by Steven Kamin, of the Federal Reserve, found that, when it came to investing in developing countries, "investors appear to be discriminating among credit risks more carefully than ever." Similarly, the U.S. government's bailout of banks this fall hasn't led them to lend rashly; indeed, they've been attacked for not lending enough. Even the example of fire insurance doesn't provide much proof of moral hazard: as it turns out, people who are insured often have fewer accidents, not more. A recent study of businesses in Taiwan suggests that this may be because companies with fire insurance actually take more precautions against fires—the reverse of what the theory of moral hazard predicts.

Why might the effects of moral hazard be smaller than expected? To begin with, most bailouts aren't like deposit insurance, which is certain and quick. Financial bailouts are uncertain and messy, and they typically occur only after institutions have already suffered extensive damage. Bear Stearns, for instance, was "saved" only after its shares had fallen almost ninety-five per cent from the previous year, and it seems unlikely that either its laid-off workers or its battered shareholders came out of the experience anxious to engage in more foolhardy behavior.

The moral-hazard argument also assumes that the most important factor shaping corporate decisions is the interest of the company as a whole. But, more often, what's shaping those decisions is the interest of individuals, and on Wall Street those interests are often only loosely connected to the long-term health of companies. The fact that people can reap enormous rewards for decisions that are beneficial in the short term but costly in the long term is likely to lead to reckless behavior, regardless of whether companies are bailed out or not. Even if we allow Citigroup to fail, after all, Chuck Prince, the former C.E.O., will still have walked away with a package reportedly worth more than seventy million dollars.

Finally, the biggest reason that moral hazard matters less than it might is that it can operate only if people actively countenance the possibility that their decisions could lead to complete disaster. But it's well documented that people generally, and investors particularly, are overconfident and significantly underestimate the chances of being wiped out. The moral-hazard fundamentalists argue that banks and other financial institutions will act recklessly if they think they'll be rescued in the event of failure. But Wall Street was reckless because it never believed that failure was even a possibility.

The patchiness of the moral-hazard argument doesn't mean that we should simply rubber-stamp another bank bailout; that may be both unjust and a poor strategy for whipping the financial sector into shape. But it does mean that the failure of Lehman Brothers was an unnecessary and costly sacrifice to moral-hazard fundamentalism. It also means that we should not sit quietly by because we fear that government action today will lead to reckless market behavior years from now. Moral hazard has its costs. But, so far, our fear of it has proved much more expensive. ♦

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