Fed Policy and Moral Hazard

By Harvey Rosenblum

Acquisitions of moral hazard have been tossed around quite a bit since the Federal Reserve lowered the federal-funds rate by half a percentage point a month ago today. Moral hazard, if you’re neither an actuary nor a practitioner of the “dismal science,” occurs when investors or property owners are protected from the downside risks of bad investment decisions, thus encouraging them to take stabs at unwise or ruinous risks in the future.

As entertaining as this discussion of the nexus between the Federal Reserve and moral hazard has been, the analysis is incomplete because it lacks one key element—something called the Taylor Rule. The namesake of this bit of economic wisdom is John Taylor, perhaps the best scholar on monetary policy in our times. His rule, a description of monetary policy decision-making formulated a decade and a half ago, has a good deal of relevance to any discussion of Fed policy and moral hazard.

Worried about ‘recession insurance’? Try living without it.

So what exactly is Taylor’s Rule? Put simply, it prescribes higher interest rates when inflation crosses certain thresholds and the economy is near full employment; and lower rates when the opposite is true. When these goals are in conflict the Rule provides guidance on how to adjust rates accordingly.

But before we get to why Mr. Taylor’s work matters, we’ve got to better understand moral hazard, which, as Mr. Bernanke defined it in a textbook he coauthored, is “the tendency of people to expend less effort protecting those goods that are insured against theft and damage.”

Why has moral hazard reared its head after the Federal Open Market Committee cut interest rates at a time of turmoil and uncertainty in financial markets? If the FOMC’s decision has provided an insurance policy that protects investor portfolios against damage, and if investor behavior takes this insurance into account in advance, then the FOMC, I will argue, does create a moral hazard each and every time it makes a monetary policy decision. This proposition is equally true whether the FOMC lowers rates, raises rates, or leaves them unchanged. Moral hazard goes with the territory.

Some writers go a step further and blame the Fed for intentionally creating moral hazard with the “Bernanke put,” an updating of the “Greenspan put.” A “put” cushions an investor against a decline in the price of a security through an option to sell at some specified price before the put’s expiration date. Former Fed Chairman Alan Greenspan’s name was attached to the concept in the mid-1990s, when stock-market investors supposedly began to believe that the FOMC wouldn’t raise the federal-funds target rate to restrain a rising stock market but would lower rates—quickly, vigorously, and intentionally—to stem stock-market declines.

If the Fed practiced such one-sided intervention, stock-market investors would suffer little or no downside risk. Sounds too good to be true and it is, as any investor who rode the roller coaster of the 80% drop in the Nasdaq in 2000-2002 would verify.

Greenspan or Bernanke “puts” make good copy, but they’re at odds with how the FOMC operates. By law, the Fed has a dual mandate to promote maximum employment and price stability. In practice, the FOMC seeks to foster an economic environment characterized by low and steady inflation, a low unemployment rate and a sustainable rate of economic growth. To carry out its mandate, the Fed needs a healthy, smoothly functioning banking and financial system.

After all, this financial infrastructure constitutes the conduit—or plumbing—through which the early actions of monetary policy flow to the rest of the economy. If the flow of money and credit is blocked, the Fed’s ability to achieve its mandates is compromised.

Financial turmoil is an impediment that must be addressed as a prerequisite to achieving the FOMC’s other goals. In a modern, credit-dependent economy like ours, a sharp reduction in the willingness or ability of lenders to extend, extend or renew credit can set off a contraction of economic activity and employment. Imagine the reduced spending in our economy if the electricity went off and we couldn’t use our credit cards for a week.

The Fed’s mandate makes no mention of the stock market, bond market, housing market or any other asset market. But these markets matter for their financial flows and for their psychological and wealth impacts on consumers and businesses. The stock market and other asset markets matter for monetary policy only insofar as they impact consumer and business spending, employment and inflationary pressures.

Fruits of the Taylor Rule

The Federal Reserve does not conduct monetary policy to influence stock prices, regardless of whether the stock market is rising or falling. The Fed does, however, try to create the macroeconomic stability needed to achieve its mandates—and this is where Mr. Taylor’s work comes in. Over the past couple of decades, the FOMC’s interest-rate behavior has been replicated closely by a forward-looking Taylor Rule, developed by my Dallas Fed colleague Evan Koenig.

Mr. Koenig’s version of the Taylor Rule suggests that the FOMC boost the federal-funds rate by roughly two percentage points if inflation is expected to rise by one percentage point or if the unemployment rate is expected to fall by one percentage point. Other things equal, the FOMC should raise the federal-funds rate by 0.7 percentage points if GDP growth is expected to rise by one percentage point. Without ever taking any account of the stock market or other asset markets, this version of the Taylor Rule, using publicly available forecasts, mimics quite closely the setting of federal-funds rates by the FOMC over the last 20 years.

Over the last two decades, when FOMC actions correlate strongly with a forward-looking Taylor Rule, the economy has been remarkably stable. Inflation has trended down, and recessions, while unavoidable, have been short, mild and infrequent. The chart nearby depicts one measure of the macroeconomic stability tied to the FOMC’s systematic reference to a Taylor-type rule. As the chart clearly points out, because of the Taylor Rule and students of it, the U.S. economy spends a lot less time mired in recession.

To the extent that the FOMC sets the federal-funds target rate in accordance with some form of the Taylor Rule, there is no central-bank “put.” There is, however, a gauntlet that the FOMC runs to earn that “put,” which can be thought of as an insurance policy that reduces the risk of recession for every worker, employer and investor.

If there is any true moral hazard in our economy right now, this is its source: Americans spend, save and invest in the belief that recessions, if they occur, will be short, mild and infrequent. People believe that unemployment is something that happens to someone else. Indeed, the younger generation in the work force has, for all intents and purposes, had almost no experience with the unpleasantness of a recession. To them, it’s just a word that begins with “R” but they cannot define it or describe it. That’s real moral hazard, because it drives their consumption and investment behavior.

So what’s the bottom line? Simply that moral hazard is an inevitable, inescapable and unavoidable byproduct of the FOMC’s provision of macroeconomic stability. The better the FOMC’s job performance, the greater the recession insurance and the moral hazard that accompanies it. And the closer we are to price stability, the fewer resources we need to expend to protect ourselves from the theft of purchasing power that stems from inflation.

So let’s stop the complaints about moral hazard and welcome the “Bernanke put.” Who wants to be the first to volunteer to live in a world like the first quarter of the Fed’s post-World War II history, when the economy was in recession over 40% of the time? There was a lot less moral hazard then, but there was also a far more volatile economy. As long as Taylor’s Rule reigns, Fed easing should be regarded as a macro blessing, not a hazard to be avoided.

Mr. Rosenblum is executive vice president and director of research at the Federal Reserve Bank of Dallas.