

PRESIDENT'S MESSAGE

Financial Stability and the Fed



This issue of *Region Focus* features a special section that explores the economic profession today, its role in society, and questions about its future. Such a discussion is timely, appropriate, and healthy for a dynamic discipline that's been much in the news lately. Still, the basic lessons of economics endure: Markets tend to organize economic activity efficiently, and government inter-

vention can sometimes have unexpected and undesirable consequences.

Given the recent events in the economy, and especially in financial markets, it's also useful to draw on research and experience of the last 30 years. While that body of knowledge provides a solid foundation for policy, the wide-ranging root causes of disruptions can be difficult to determine. And when events require swift and direct policy responses in real time, the job gets even tougher. The Fed's role as lender of last resort often faces the institution with difficult choices when financial disruptions unfold.

In an episode of financial disruption, central bank lending may prevent a bank run and put off costly closure or liquidation. (Bank runs occur when depositors fear that a bank's assets can't cover its liabilities, and depositors cash out en masse.) But if the financial sector is just coping with deteriorating fundamentals, central bank lending distorts economic allocations by artificially supporting the prices of some assets and liabilities of some market participants. Government support in this latter case can intensify the "moral hazard" problem inherent in any financial safety net.

Applying this framework to recent policy actions can help provide some perspective. As the slowdown in housing markets and the associated decline in home prices began, it became clear that the securities backed by mortgages originated in 2006 and early 2007 would perform significantly worse than anticipated. This realization affected the future prospects of any institution or financial instrument with mortgage-related exposure. The recent instances of run-like behavior, such as those that afflicted Bear Stearns in the week leading up to its acquisition, seemed to reflect increased concern about the quality of these sorts of financial products. In short, it appeared to be what we would classify as a deterioration in market fundamentals, not a liquidity crisis.

Perhaps most important to the current debate is the fact that market expectations of central bank response in times of stress can affect the robustness of the system. In the

short-term, governments and central banks may relieve financial market strains, but the intervention itself may affect future choices of financial institutions. These new expectations could make future crises more likely.

If banks and other financial institutions assume central bank support in the future, then they are less likely to put in place the necessary and appropriate safeguards. That assistance interferes with market discipline and distorts market prices.

If intervention is assumed, then there's scant incentive for banks to take costly alternative action to prevent adverse consequences. But there is an alternative. New research by economists at the Richmond and New York Fed banks considers a scenario in which there is absolute certainty that no government or central bank assistance will be forthcoming. In such a world, banking contracts would likely include provisions that allow for suspensions of payment. These contracts will prevent the type of run that may occur because of the perceived quality of its assets. This sort of contract actually has its roots in the 19th century U.S. banking panics.

The Fed's lending policy can play a role in the stability of financial markets. As we learn more about the causes and nature of financial instability, I believe we should strive for policy that is informed by lessons about price stability learned in the 1980s. That's when the Fed committed itself to a long-term goal of maintaining a low and stable inflation rate. We will achieve better outcomes if we can establish credibility for a pattern of behavior consistent with that objective.

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