Central Banks and Moral Hazard

It is time for central banks to back away. Not from raising or cutting rates. It is time for them to extricate themselves from any activities that might distort market prices.

It is time for governments to back away. The economic purpose of government should be to provide frameworks and systemic infrastructure, and to only provide goods and services that the free market is unable to provide. Beyond that government should back away.

As long as regulators and policymakers maintain a safety net, there is no interest for the private individual to be prudent or diligent.

There is no interest to save for the future. No interest to invest for the future. No interest to assess the risk of an endeavor. No interest to live within one's means. No responsibility for one's own actions.

Without a safety net would we take out that mortgage we could not service on that house we could not afford, or buy that car or that watch?

Would we invest in the stock of that company we didn't understand, that fund we didn't do due diligence on, that structured product without reading the prospectus?

Ex Fed Chairman Greenspan's statement that he would not act pre-emptively to deflate bubbles, since he could not recognize a bubble, but would instead step in to rescue a post bubble economy is nothing more than an explicit guarantee of state aid to the economy and asset prices. The asymmetry of such policy and the moral hazard it creates is remarkable. As remarkable is the market's propensity to regard the policy as prudent.

The current situation is no different from the era of the Greenspan Put. While in 2008 it was necessary to intervene in the markets to maintain orderly function of the key infrastructure of finance, that time has long passed.

It is not beyond logical contemplation to ascribe the crisis to active central bank policy. While inflation fighting was a useful function some 2 decades ago, the signaling power of central bank policy overtook the real impact of policy. Expectations of effective policy in maintaining price and economic stability led to excessive risk taking and irresponsible financial planning by the private sector.

Ironically, the existence of a lender of last resort and a unilateral determinant of short term interest rates with a mandate for maintaining economic stability, while effective in the short run can be and has proven to be de-stabilizing in the long run.