Chapter 3

FINANCIAL CRISES AND THE CHALLENGE OF "MORAL HAZARD"

In the innumerable discussions and debates about Asia's financial turmoil, typically dated from the collapse of the Thai baht on July 2, 1997, the standard script includes an acknowledgment of a phenomenon called "moral hazard" (hereafter referred to as MH). Once MH has been acknowledged, the script calls for it thereafter to be passed over lightly, if not entirely ignored, in favor of other explanations and terminology, including such evocative terms as "financial contagion," "herd-like behavior," "speculative currency attacks," and "predatory hedge-fund speculators."

Although MH is familiar in the lexicon of economists, it has a distinctly "other social-science-besides-economics" tonality. The purpose of this note is to prod other social scientists to provide some insight concerning a phenomenon of central importance, both as a contributing cause and aggravated consequence, of Asia's financial turmoil, its repercussions in Russia, Brazil, Japan, and the United States, and its implications for the recurrence of financial crises in the future.

"Moral hazard" is a disposition on the part of individuals or organizations to engage in riskier behavior, than they otherwise would, because of a tacit assumption that someone else will bear part or all of the costs and consequences if the incurred risk turns out badly. Similarly, but somewhat more formally, MH is defined in the economics

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*A slightly edited version was published in **Society**, July/August 1999, under the same title.*

literature as: "actions by economic agents in maximizing their own utility to the detriment of others in situations where they do not bear the full consequences . . . of their actions."[1]

The concept, but not the term, is evident in Adam Smith's *Wealth of Nations*, but the term's origin itself is obscure. One can think of other terms that would be at least equally descriptive of the phenomenon without invoking the "moral" ingredient—for example, "conflicted interests," or "mixed incentives." Smith, of course, was himself a professor of *Moral* Philosophy.

I conjecture that derivation of the term MH may owe more to Immanuel Kant, a contemporary of Smith's, than to Smith. Kant's moral imperative asserts that a moral action is one that provides a just and fair precept for the actions of others—a broad and general statement of the golden rule. With this imperative as a standard, the mixed incentives prevailing when responsibility for actions is divorced from responsibility for consequences presents a *hazard* to moral behavior.

MH is certainly not unique in the financial domain. Indeed, it occurs in many aspects and stages of quotidian life. For example, a child may be more disposed to get into one or another kind of trouble because of a belief that her parents will get her out of it; an adolescent may occasionally overspend from his allowance because of prior experience that his parents, perhaps contrary to their expressions of intent, will bridge the gap.

The phenomenon of MH is also pervasively associated with insurance policies, and the behavioral effects they may have. For example, automobile liability insurance may in some cases conduce to less careful driving, and fire insurance on a home perhaps reduces incentives to substitute less flammable for flammable materials, such as tile roofing in place of wood shingles. And even health insurance may sometimes result in excessive utilization of health care services, or in avoiding preventive care, or deferring changes in life-style that would reduce the need for health care.

However, there are at least two important differences between some of these insurance transactions and the MH phenomenon in the fi-

[1] *The New Palgrave: A Dictionary of Economics,* Vol. 3, 1987, p. 547.

nancial context. First, in the case of insurance-induced MH, the premiums paid for policies represent a cost paid by the insured that is not directly matched in the case of IMF-bailout provisions to rescue insolvent or illiquid debtors, as in the Mexican financial crisis of 1994, and the Asian crisis since 1997. Second, it is frequently, though not uniformly, the case in insurance transactions that premiums are based on performance and experience, so that the effect of MH on the behavior of insured parties may raise their subsequent premiums costs if indeed the frequency of their requesting insurance claims rises above actuarial calculations.

This is not to say that MH was the principal cause of the Asian financial crisis and its repercussions. However, it is reasonable to suggest that MH operated as a prominent part of the circumstances encouraging risky and overoptimistic behaviors by lenders, borrowers, and other economic actors, directly leading to the Asian financial troubles. These imprudent behaviors included the following components:

1. for individual, corporate, and sovereign borrowers, motivation toward excessive short-term borrowing derived from interest-rate arbitraging between *low* rate hard-currency loans and high interest rate charges on own-currency relending for domestic real estate or other investment;
2. for many money-center banks in Europe, Japan, and the United States, motivation toward excessive lending resulted from a desire to boost their volume and turnover, and hence profits, because of the low costs to the lenders of raising funds domestically, and
3. overvalued exchange rates in the borrowers' countries due to currencies pegged to the dollar at rates that were sustainable only as long as there was a continued inflow of short-term funds from abroad.

It is doubtless that the principal actors engaging in these behaviors were keenly aware of the prior and partly similar predicament of Mexico three years earlier, which was salvaged by a large inflow of bailout funds from the United States and the IMF. So, MH was pervasively operative—that is, a belief that if these behaviors were to run amiss, some type of cushion would be provided by multilateral or bilateral sources. Now that the IMF's capital has been replenished from new subscriptions by the United States to its funding base and prospectively by other countries, and with the Asian Development Bank as another source of "last resort," bailout funding, the prospect is that the MH phenomenon will be reinforced, with baleful consequences in the future.

What sorts of remedies, or at least palliatives, can be devised to offset the operation of moral-hazard behaviors? In the realm of public policy, at least two sorts of remedies may be envisaged. One possible remedy is to allow the financial markets' own homeostasis processes to operate. For example, creditor institutions collectively would bear the responsibility for deciding whether to incur an actual default on debt owed to them, or to organize and share in providing roll-over financing subject to conditions levied on the debtors by the creditor consortium, rather than by governmental bodies.

Another policy course might be to consider the suggestion made by George Soros to set up a multilateral International Credit Insurance Corporation to provide loan guarantees for emerging-market borrowing. Soros's proposal, presented in his recent book *The Crisis of Global Capitalism*, would involve funding the ICIC through the Group of Seven (G-7) and IMF—hence, by the taxpayers of the G-7 countries. An alternative, as well as an improvement, upon this scheme would be to have the corporate financial community self-fund the ICIC through premium charges that might conceivably be performance-based. A performance-based premium schedule would ease, if not fully resolve, the MH problem because unnecessarily risky behavior would, over time, be penalized by charging a higher premium for wayward members of the insurance pool.

From an academic and analytic point of view, the moral hazard issue provides a challenge to the social science community—one that is not confined to economics and economists, whose treatment of the problem has been inconclusive, as well as controversial. As examples of the unresolved controversy, note the following assertions by economists concerned with the Asian financial crisis:

> "There is little, if any, dispute about whether the IMF assistance packages create moral-hazard incentives that could increase the likelihood and severity of financial crises. The unresolved issue is

> the extent to which susceptible parties have acted on the incentives."[2]

By way of contrast, another economist opines:

> "The. . . 'moral-hazard' critique . . . is unrealistic . . . the suffering that a country in crisis endures is already so severe that risk-prone parties quickly learn their lesson without lectures about moral-hazard from well-meaning economists."[3]

And finally, George Soros avers that:

> "The IMF is part of the problem, not the solution."[4]

Perhaps other social scientists besides economists can help to illuminate the concept of MH, and suggest remedies for its perverse effects.

Postaudit

Moral hazard remains a serious and pervasive problem to which too little attention is devoted in both academic and policy circles.

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[2]James Barth, Dan Bumbaugh, Lalita Ramesh, and Glenn Yago. "The East Asian Banking Crisis." *Jobs and Capital,* Summer/Fall 1998, p. 35.

[3]David Hale. "The IMF, Now More Than Ever." *Foreign Affairs,* November/December 1998, p.10.

[4]George Soros. *The Crisis of Global Capitalism*. Public Affairs Press, 1998, p. 148.