Beware the Bailout

The fear of a bailout whether of a plunging foreign currency by the world bank or of overextended home owners and reckless lenders, both prime and subprime, is what economists call a ‘moral hazard’.
By not making the risk taker bear the full brunt of his risky or foolish decision, we only encourage more risky and foolish decisions. On an individual level you can not teach one to make good decisions by protecting them from the consequences of bad decisions.

In the national and global economy the morality of a bailout is much more complicated. While we do not want to make the taxpayers pay for bad decisions in the private markets, we also like to avoid the fallout of these decisions and market adjustments from infecting the broader populace.

Thus while we bailed out currency failures in Mexico, Thailand, Indonesia and other countries during the Clinton adminsitrations and into the first Bush administration, it was rationalized by the greater desire to restore order to the currency market. The bailout of the savings and loan industry in the late 1980’s was similarly treated.

Current proposals to bail out the home owners and some lenders in the current mortgage problem will face the same question of balance. You want to let the market inflict enough pain to discourage the stupid practices that prevailed, but you want to be sure there is not irrepairable damage to the market itself.

More often than not the market will repair itself quicker with less government intrusion than with more; but few politicians from either party can resist the call for help. The worst among them will contend that such market excesses justify the need for continued governemnt intrusion into private capital markets.