Editorial & Opinion

Ensure that the cost of private debt is not socialised

The expectation that failed banks would be bailed out by the government means that similar financial crises are bound to be repeated, comments Frank Flatters.

The Asian financial crisis was a major topic at the G-7 finance ministers meeting last month. One of the conclusions, summarised by United States Treasury Secretary Robert Rubin, was that “in future crises, the private sector should bear a higher share of the costs.”

That there is anything other than the private sector to share in the costs of reckless market behaviour or misguided economic policies is a dangerous myth. The cost of bad policies or abuse of the market is always borne by individuals. The government, or the public sector, can help to reduce (or increase) the costs of financial crises; it can set the rules that determine who bears them. But the public sector itself cannot bear these costs. They are always paid, in one way or another, by individuals.

Governments in the region have already committed themselves to significant bailouts. Depositors and creditors, foreign and domestic, have been promised partial or complete compensation for the costs arising from failures of banks and finance companies. But there should be no misunderstanding of one basic fact: the direct costs of these bailouts will be borne, not by the ‘government’, but by taxpayers and citizens of the countries offering this compensation.

The major cause of the current crisis was the expectation that there were government guarantees of a) fixed or at least highly predictable foreign exchange rates of local currencies, and most importantly, b) substantial public underwriting of the costs of financial failures.

The latter was the most dangerous belief. It was based in part on experience of past crises, and in part on the prediction that, faced with a crisis, major financial players and international institutions would convince governments to act this way “to prevent complete systemic collapse.”

They were right. Immediately following the collapse of the won, South Korea was besieged by a team of international bankers, led by J.P. Morgan, arguing that the Korean banks’ debts should be converted into guaranteed public sector debt. In Thailand, even the World Bank advised the government to guarantee repayment of the private loans made by major domestic and international lenders.

In Korea, there was some discussion of the interest rate that would be paid by the government. And in Thailand, there was fruitful discussion of the terms under which the repayments would be provided. But the desirability of a bailout was never seriously questioned.

None of this should be surprising. Those with the biggest stakes and the best understanding of the implications of government policies will have the greatest incentive to influence policies in their own favour. For a major financial house, the implications of bailouts are enormous. Witness the rush of foreign bankers to Government House at the onslaught of the crisis to pressure the government for absolute guarantees to creditors. And pity the unwitting taxpayers who were being told that the ‘government’ needed to undertake these policies in order to ‘prevent the system from collapsing’.

To protect themselves, it is essential that taxpayers, and indeed all citizens who depend in one way or another on government services, understand that there is no ‘government’ to pay the costs of these measures. It is Thai citizens who will have to bear the burden of financial bailouts. They need to realise that, ‘I have seen the government, and it is me!’

Major domestic and international financial houses were fully aware of the commercial risks of the loans they were making to Thai financial institutions in recent years. But, armed with the (naive) hope that they could outguess the market, and the (less naive) belief that local taxpayers could be duped into rescuing them when the bubble burst, the ‘fools’ continued to rush in. In the end, the government turned Thai taxpayers into the biggest fools of all.

Rubin was alluding to a fundamental and very important economic problem – known by economists as a ‘moral hazard’. The problem is that, as they have reason to believe they will be protected from any of its negative consequences, agents have inadequate incentive to avoid dangerous and harmful behaviour. Under the current system of ‘government-backed’ credit guarantees, banks are encouraged to engage in excessively risky investments.

Unfortunately, influential bankers and financial dealers prefer to keep the current system in place, leaving the moral hazard problem unsolved. Without strong political pressure from other sources, therefore, the problem will remain, and financial crises are bound to be repeated.

The fundamental ‘moral hazard’ problem alluded to by Rubin will not be solved simply by wise men's discussions. And it certainly will not be helped as long as these wise men talk, like Rubin, as if there is an impersonal and bountiful ‘government’ that will bear the costs. The persons who have to pay the costs need to be fully aware that the existence of such a bountiful government is a myth. They need to voice their protests at the injustice and the economic waste caused by the current responses to financial crises. They need to push for new rules, under which irresponsible investors personally bear the costs of their actions.

Food rioters who are wrecking Chinese businesses in Indonesia and suffering taxpayers in Thailand need to understand the real reasons for their pain. Only then will there be some hope of solving the systemic problems that have lead to this crisis and which, if not corrected, will lead to many more in the future.

Dr Frank Flatters is Professor of Economics at Queen’s University in Kingston, Canada. He also works as a policy researcher and adviser in the Asian region.

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