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Financial Services Committee Hearing

"Monetary Policy and the State of the Economy"

February 27, 2008

Mr. Chairman,

A topic that is on the lips of many people during the past few months, and one with which I have greatly concerned myself, is that of moral hazard. We hear cries from all corners, from politicians, journalists, economists, businessmen, and citizens, clamoring for the federal government to intervene in the economy in order to forestall a calamitous recession. During the boom, many of these same individuals called for no end to the Fed's easy credit. Now that the consequences of that easy money policy are coming home to roost, no one wants to face those ill effects.

We have already seen a plan from the administration to freeze mortgages, a plan which is alleged to be only a temporary program. As with other programs that have come through this committee, I believe we ought to learn from history and realize that "temporary" programs are almost anything but temporary. When this program expires and mortgage rates reset, we will see new calls for a rate-freeze plan, maybe for two years, maybe for five, or maybe for more.

Some drastic proposals have called for the federal government to purchase existing mortgages and take upon itself the process of rewriting these and guaranteeing the resulting new mortgages. Aside from exposing the government to tens of billions of dollars of potentially defaulting mortgages, the burden of which will ultimately fall on the taxpayers, this type of plan would embed the federal government even deeper into the housing market and perpetuate instability. The Congress has, over the past decades, relentlessly pushed for increased rates of homeownership among people who have always been viewed by the market as poor credit risks. Various means and incentives have been used by the government, but behind all the actions of lenders has been an implicit belief in a federal bailout in the event of a crisis.

What all of these proposed bailouts fail to mention is the moral hazard to which bailouts lead. If the federal government bails out banks, investors, or homeowners, the lessons of sound investment and fiscal discipline will not take hold. We can see this in the financial markets in the boom and bust of the business cycle. The Fed's manipulation of interest rates results in malinvestment which, when it is discovered, leads to economic contraction and liquidation of malinvested resources. But the Fed never allows a complete shakeout, so that before a return to a sound market can occur, the Fed has already bailed out numerous market participants by undertaking another bout of loose money before the effects of the last business cycle have worked their way through the economy.

Many market actors therefore continue to undertake risky investments and expect that in the future, if their investments go south, that the Fed would and should intervene by creating more money and credit. The result of these bailouts is that each successive recession runs the risk of becoming larger and more severe, requiring a stronger reaction by the Fed. Eventually, however, the Fed begins to run out of room in which to maneuver, a problem we are facing today.

I urge my colleagues to resist the temptation to call for easy fixes in the form of bailouts. If we fail to address and stem the problem of moral hazard, we are doomed to experience repeated severe economic crises.