

In an address to the Cato Institute in Washington on Nov. 30, **President William Poole** speaks on his research into market declines going back to 1950.



## Bailing Out the Markets Is Not a Goal of Fed Policy

In some circles today, there is talk that the Fed is, once again, bailing out greedy investors. This time, the Fed is supposedly running to the aid of those who bought securities backed by subprime mortgages, which, of course, have plummeted in value as homebuyers have defaulted on the mortgages.

There's some truth to this argument, but it is important to understand the circumstances under which the Fed responds to market distress. Actions by the Fed in the wake of the subprime mess have helped out these investors by buoying flagging prices on securities in general. However, bailing out those with deep pockets, or nearly bankrupt pockets for that matter, has never been the goal of the Fed, nor is it this time around.

First, let's be clear that the Fed never bails out any party—even banks—with capital or any sort of guarantee. Instead, the Fed has only monetary policy tools—mainly raising and lowering interest rate targets, and making sure money is available to lend—to “bail out” the economy.

Those last two words are key: the economy. The Fed's job is to stabilize the economy—“bail out” with its pejorative connotations is altogether the wrong term. Whenever the Fed steps in to deal with financial instability, its intent is to stabilize the overall economy, not just one segment of it, such as Wall Street. I reviewed all stock market declines of at least 10 percent going back to 1950, along with actions by the Federal Open Market Committee over the same span. The data prove that the FOMC has not lowered interest rates in systematic fashion at the time of stock market declines. (See our web site for details.)

To those who say that the parties responsible for this subprime mess need to be taught a lesson, do not worry. The Fed's monetary policy will not shield from loss those who invest in failed strategies. The Fed is less concerned about whether investors can sell their subprime paper at 30 or

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70 cents on the dollar than whether they can find a buyer at all. For more than three months, the market in subprime paper has been almost nonexistent. An active financial market is central to economic growth; it is that market process, not prices in financial markets per se, that the Fed cares about.

Others are worrying that if subprime investors benefit from Fed monetary policy, then the Fed is creating a moral hazard—encouraging others to take the risks because they think that the Fed will, at some point, step in to stanch the bleeding. But these people don't realize that these “bailouts” are only occurring when the Fed is concerned that a financial upset could turn into an overall economic crisis. Fed policy does not protect imprudent lenders, such as those now holding subprime loans gone bad.

Knowing that the Fed will step in to deal with true financial shocks gives everyone, including investors, the confidence to take risks at the microeconomic level, risks that lead to innovation, which, in turns, leads to growth for the economy as a whole.

For those who still think the Fed should never step in when financial markets decline, consider this extreme case (which I offer as a provocation to promote careful analysis and not as an example directly relevant to today's circumstances):

*Fact: The U.S. stock market between its peak in 1929 and its trough in 1932 declined by 85 percent. Question 1: If the Fed had followed a more expansionary policy in 1930-32, sufficient to avoid the Great Depression, would the stock market have declined so much? Question 2: Assuming that a more expansionary monetary policy would have supported the stock market to some degree in 1930-32, would it be accurate to say that the Fed had “bailed out” equity investors and created moral hazard by doing so?*

Does anyone doubt that it would have been a good idea to avoid the Great Depression? [📌](#)