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## Worry Less About Systemic Risk, More About Inflation

Over the past 16 months or so, there has been great concern in the U.S. over systemic risk—the possibility that the sudden failure of a financial firm may start a cascading effect among healthy financial firms, causing these firms to fail as well. The potential for lasting damage to the financial intermediation sector of the economy could be severe under such a scenario.

The worries over systemic risk have been used to justify much of the policy action of the Federal Reserve over the past 16 months. But systemic risk is a notoriously slippery concept and, so, may not provide the best foundation for sound monetary policy.

In principle, any large corporation that fails will affect its partners in business, including suppliers and customers. If a major automotive manufacturer were to fail, for instance, scores of businesses that supply the manufacturer would be impacted and might also close up shop. But generally, non-financial firms are not thought to pose a systemic risk. We can allow bankruptcy court to handle failures of nonfinancial firms.

Financial firms are thought to be more vulnerable because they have significant exposure to one another through interbank deposit markets, transactions in over-the-counter derivatives, and wholesale payment and settlement systems—connections that other businesses do not have. The speed with which transactions occur makes it difficult to accurately evaluate the riskiness of the assets. Financial institutions are vulnerable, too, because of their comparatively thin capital margins, which leave them less able than other types of businesses to absorb losses.

Systemic risk would not always be a concern even for financial firms. In the recent history of financial markets, there have been

major failures that did not seem to have a systemic effect on the market. Among these are Drexel Burnham Lambert in 1990, Barings Bank in 1995, Long Term Capital Management in 1998, Enron in 2001 and Amaranth Advisors in 2006. Some of these failures involved a measure of government intervention; others did not. But none of these seemed to trigger a paralyzing domino effect.

More recently, the Federal Reserve facilitated the acquisition of Bear Stearns by JP Morgan Chase. The failure of a key investment bank was surprising, as these

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kinds of institutions are perceived to be both profitable and stable. The rationale for the intervention was that other financial institutions doing business with Bear Stearns might be caught by surprise, creating the possibility that they also would be put out of business. This might cause severe damage to the U.S. financial system.

An important part of this story is the unexpected, or surprise, component. But is it reasonable to assume that financial firms may still be surprised if a partner company goes out of business once the crisis has been rolling on for more than a year? Probably not. Instead, players are pricing the chance of failure into their business dealings with

questionable firms, demanding higher interest rates on repayments, for example. If a shaky firm fails, its healthy business partners may lose money, but they have thought about and protected themselves against outright failure.

The premise of systemic risk is the unexpected failure. To the extent that the possibility of failure is anticipated, then it is priced into the market. That is, agents and institutions have adjusted the price of transactions to reflect the probability that a given institution may go out of business.

Systemic risk worries are having a large impact on monetary policy. Inflation problems are brewing as we wait for financial markets to repair. Evidence of systemic risk in recent U.S. financial history is weak, however. At this point, it does not seem likely that the failure of a major financial firm would be a significant, unpriced event. The financial crisis has gone on for too long—the surprise factor is gone. Some institutions may fail as part of a normal industry shake-out in reaction to the large shock originating in the housing sector. Those with better management will make changes and survive. But a failure by itself cannot be surprising at this point. 

