ECO 301: Money and Banking **Name:** (20 points) ____________________

In-class Exercise

Economic Stabilization Policy and Moral Hazard

Learning Objectives:

- LO1: Understand and appreciate the importance of financial markets for the overall functioning of the economy.
- LO5: Analyze macroeconomic problems and prescribe appropriate monetary policy solutions.

Directions: Read the *Wall Street Journal* article, "Greek Deal Stirs Moral Hazard Concerns" from February 11, 2010. Work in groups of up to four people and answer the following questions based on the article. All papers will be collected, but only one member's paper will be randomly selected and graded and all members of the group will receive the same grade.

By signing below, you agree that the following work represents the efforts of everyone in the group, and you are willing to accept as your own grade for the group project the grade earned from this representation of your group's work. Every member must agree to these terms to earn a non-zero grade for this assignment.

Signature Group Member 1	Print Name	Date
Signature Group Member 2	Print Name	Date
Signature Group Member 3	Print Name	Date
Signature Group Member 4	Print Name	Date

1. (10 points) In only one or two sentences, describe the concept of *moral hazard* within the context of the bond market (this can be answered from class content, not from the article).

2. (10 points) In only one or two sentences, describe the concept of *moral hazard* within the context of insurance (this can be answered from class content, not from the article).

3. (10 points) Describe the concept of *moral hazard* within the context of a bailout for Greek sovereign debt. Are the negative effects from moral hazard long-term or short-term. Explain.

4. (10 points) How does John Taylor suggest implementing a Greek sovereign debt bailout while minimizing the effect of moral hazard? What specific policies would you suggest along these lines?

5. (10 points) Discuss the negative consequences to both Greece and the Euro area of conducting a bailout while mitigating the effects of moral hazard along the lines suggested by John Taylor. Are the negative effects long-term or short term?

6. (10 points) Refusing to bailout Greece's soveriegn debt obligations would avoid the moral hazard consequence. Discuss the negative consequences for a lack of intervention to both Greece and the Euro area. You might need to do some speculation or use some logical reasoning outside of article and class content to answer this question.

7. (10 points) One may argue the problem of moral hazard existed with the introduction of the Euro as a common currency, that the problem was not created only recently with the talk of sovereign debt bailouts. Explain such an argument.

8. (1,000,000 bonus points) Suggest a solution to Greece's sovereign debt crisis that mitigates all the problems discussed above.

For more recent news on the continuing Greek bailout efforts, see this Oct 7 2016 WJS article:

"IMF, Citing Risks to Bailout, Hesitates on More Aid"
http://tinyurl.com/wsjgreece

THE WALL STREET JOURNAL.

http://www.wsj.com/articles/SB10001424052748704140104575057631234463158

EUROPE

Greek Deal Stirs Moral Hazard Concerns

Any Deal by European Officials to Guarantee the Debt of Greece and Other Troubled Nations Might Keep the Crisis From Worsening, but It Raises Another Big Problem: Moral Hazard.

Public workers protested government plans for austerity measures with demonstrations Wednesday in Athens. *AGENCE FRANCE-PRESSE/GETTY IMAGES*

By **TOM LAURICELLA**
Updated Feb. 11, 2010 12:01 a.m. ET

Any deal by European officials to guarantee the debt of Greece and other troubled nations might keep the crisis from worsening, but it raises another big problem: moral hazard.

The concern is that by rescuing a country that for years flouted fiscal discipline, the European Union would be encouraging such behavior rather than discouraging it. One of the strengths of the euro was the idea that when a country joined the European Union it was a one-way trip that came with strict fiscal responsibilities. A loan-backstop program could change that perception.

The moral hazard problem "is real," says John Taylor, chief investment officer at currency managers FX Concepts. "Any rescue has to be nasty enough that nobody wants to be in a position to be rescued."

But that puts European officials in a bind. If a loan bailout became necessary and was imposed with the kind of harsh measures that would eliminate moral hazard, it could do significant damage to local economies, especially already-fragile banks.

In the end, officials may not have a choice but come up with a plan that can be seen as creating some kind of moral hazard, analysts say.

Given signs that the troubles in Greece and other Mediterranean countries were beginning to infect markets in the relatively healthy core of Europe, the lack of a debt-guarantee program could set the markets right back on the path to contagion. Some argue that in the end, averting a debilitating financial crisis will matter more to investors than moral hazard.

Financial markets spent Wednesday in a waiting mode, whipsawed between conflicting news stories about the likelihood of a loan bailout. On Tuesday the euro rebounded strongly from below $1.37 on news that a plan was in the works. But as some reports cast doubt on the idea that a plan was imminent, the currency fell back toward $1.37 before recovering to $1.3730.

In the short run, a guarantee plan is seen by most as a positive for the euro. Amid fears that the problems in Greece would spread, investors had been pulling money out of European financial markets and buying U.S. dollars or yen.

"While there's still a question about how things will proceed ... to alleviate the potential default of a member country–that would be a good thing," says Robert Lynch, currency strategist at HSBC Bank in New York.

But the longer-term implications are less clearly positive.

"A bailout implies 'moral hazard'," analysts at BNP Paribas wrote last week. "Lack of market-driven discipline due to the '(European Monetary Union) umbrella' has certainly been one of the factors contributing to the buildup of imbalances in Greece and elsewhere. Bailing Greece out would give a signal to other countries, limiting the incentives to undergo the needed adjustment as they gain fiscal 'impunity'."

In addition, if a bailout leads to the euro resuming the climb it enjoyed last year, the result could actually be a negative for European economies. In November the euro was changing hands just shy of $1.50.

"It's a catch-22," says David Gilmore, economist at Foreign Exchange Analytics. The recent declines in the euro "are doing wonders for European competitiveness at a time when they are crawling out of recession," he adds.

In turn, eventually a bailout would be negative for the euro as it would weaken the overall economic strength of the region, said Tim Backshall, chief strategist at Credit Derivatives Research, an independent research firm in New York. Debt levels would rise across the euro zone and forced austerity measures would reduce overall economic growth, he said.

Others, however, say that in the current circumstances, the benefits of a bailout won't necessarily come with the unwanted baggage.

One reason is that it is no longer seen as just a problem facing a single economy—Greece—and instead as something that poses a challenge for all members of the European Union, says Mark Schofield, global head of interest-rate strategy at Citigroup in London. In addition, the current government in Greece appears to be taking the situation seriously. A loan-guarantee plan "is not Greece trying to take the easy way out," Mr. Schofield says.

The idea, he says, "would be to try and make a decent fix of it in the near term and at least get some time to deal with the structural problems."

And for the governments that would be helping Greece, he adds, "you can argue that provided you are conscious of (moral hazard) and going into it with your eyes open, you can deal with that going forward."

Laurence Mutkin, chief European interest-rate strategist at Morgan Stanley, says investors don't have to look far for an example of bailouts that avoid moral hazard—for example, those by the International Monetary Fund.

"If you look at what the IMF does, it gives support on a contingent basis," he says. But for the countries that get rescued, it comes with an "economic and political cost."

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