

The Moral Hazard of Donald J. Trump

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A few weeks ago Republican Senators had the opportunity to remove Donald Trump from office on charges of abuse of power and obstruction of Congress. Now, as the S&P 500 stock index stands nearly 13% below its most recent high after falling by more than 3% three times in the past week, they are literally paying the price for their inaction. Although a few people, including President Trump, have tried to argue that the reason for this drop is fear that Bernie Sanders might soon be our next President, the predominant explanation for this market correction is fear there will be a global pandemic of the COVID-19 coronavirus. On Wednesday night, February 26, 2020, the President gave a press conference that was supposed to calm investors. Instead, it sparked a plunge of another 4.4% the next day.

There has been much speculation on the air waves and internet about why exactly Trump has been so spectacularly incapable of reassuring the world that his administration has things under control. I want to focus attention on the fact that it was virtually inevitable that we would wind up in a situation like this after the Senate left Trump in office. By doing so, they created what economists call a “moral hazard” problem. When Treasury Secretary Hank Paulson allowed Lehman Brothers to go bankrupt during the George W. Bush Administration, triggering the global financial crisis that made the Great Recession so “great”, he was hoping to avoid this trap. It is also the reason why so many Republicans (and Democrats) bewailed the massive wave of bailouts that followed in order to prevent the recession from becoming a depression. Perhaps most relevantly, moral hazard is the reason why American banks no longer lend to Donald Trump on account of his long record of bankruptcies.

Moral hazard arises when there are two or more parties, say A and B, and A expects certain behavior from B, yet has no means to enforce or verify that B will conform to these expectations. The canonical example of moral hazard involves insurance policies. For example, a car insurance company (A) would like the drivers (B) it insures to drive responsibly. However, the fact that someone has car insurance relieves that person of some of the consequences of driving irresponsibly. As a result, insurance companies charge higher premiums than they otherwise would if everyone could be trusted to drive appropriately.

As the financial examples cited above indicate, the financial sector is especially susceptible to moral hazard since it exists to direct the savings of households and institutions to worthwhile projects. Lenders and investors expect their money will be used for the purpose stated up front. However, their ability to ensure that is what actually happens with their money is limited. One of the main reasons why the financial industry offers such a wide variety of relationships and instruments is an effort to reduce the frictions caused by this moral hazard. Since most people do not have the time or the inclination to verify for themselves that their savings are being used properly, banks evolved to do that for us. In the case of Donald Trump,

most reputable banks, at least in the United States, determined that, given his history of not repaying loans, there are no lending terms that will satisfactorily resolve the moral hazard problem so they stopped lending to him altogether.

A circumstance that lenders are particularly keen to avoid is one where the borrower still has funds available but knows he is not likely to be able to repay his debt in its entirety. This is problematic because bankruptcy laws limit how much of a borrower's remaining assets can be taken by creditors in the event that he defaults. Downside risk for the borrower is fixed while the potential upside is unbounded. The borrower can put any remaining funds into risky ventures, like going to Las Vegas, that might conceivably pay a huge return. In so doing, he is effectively gambling with the lender's assets since he gets to keep any winnings net of what he owes even though he is not staking any of his own wealth. This is why there was so much consternation about bailing out failed financial firms during the Great Recession. The fear was that the government was giving these firms license to gamble with taxpayer money. Financial firms might make even riskier bets in the future with the expectation that they too will get bailed out if their wagers fail.

What does this have to do with Trump as President? Voters have empowered Trump as our chief executive to act on our behalf. However, the litany of crimes that Trump has not even been charged with yet (because of a Department of Justice opinion that a sitting President cannot be indicted) would probably make Bernie Madoff blush. Trump fears that when he leaves the Oval Office he will likely be facing a lifetime of criminal prosecution or prison, and he has made it clear that he does not really care about anything except his own welfare. Other Presidents could be trusted to take their responsibility to the American people seriously. Trump cannot be so trusted.

With the coronavirus threatening the world economy, Trump is like a borrower who has no hope of repaying his loan without taking exorbitant chances. The one argument he had for reelection was a sound economy that should not be messed with. Other world leaders might make the argument that a global pandemic is something they have no control over so they should not be blamed for its effects on the economy under their watch. Trump has already made too many mistakes to convince anyone who is not a diehard supporter that what happens is not at least partially his fault. With the bureaucracy set up by Obama to deal with contagious diseases, America should have been leading the global response to the coronavirus. But Trump dismantled that apparatus, so instead of leading we are struggling to catch up. While other countries have tested thousands of their people—Britain even has drive-thru testing—we have only tested a few hundred. Even after we have had our first confirmed fatality in the United States, the President is still trying to sell the absurdity that the worst is behind us. We have no idea how many of us are already infected.

Faced with a disease as contagious as COVID-19, there are basically two options. One is to let the virus run its course. With an apparent lethality rate of 2%, this could mean a few

million American deaths. The other is to implement strict quarantine procedures to contain the virus like China, Japan, South Korea, and Italy have already done. That, however, would almost certainly push the United States into a recession. An economy needs workers at their jobs to produce the goods and services that provide the income that pays for their consumption. Most of us cannot telecommute without a substantial loss of output.

So far, Trump is letting the virus run its course. The only restrictions he has imposed are on international travel, though he has offered the comforting words that “[It's going to disappear. One day it's like a miracle, it will disappear.](#)” A miracle is the only hope left for him. He is gambling with our lives, and it really ought to be no surprise to anyone that it would come to this.