

## Comments

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I will respond selectively rather than comprehensively to the important list of questions posed to the panelists.

A paraphrase of some of these questions is: Should the central bank respond to financial dysfunction, and does the central bank encourage excessive risk-taking by so doing. It is not easy to distinguish between excessive and optimal risk-taking. But I do think that there are some general principles that should guide central bank behavior, and that will be the subject of my brief remarks.

These principles include the view that cries for help from financial institutions, the housing industry, and advocates for homeowners deserve a sympathetic hearing at the central bank. But that is not because it is the job of the central bank to prevent particular businesses from failing or to make whole homeowners whose housing values haven't performed as homeowners had expected. I would hope that everyone, even central bankers, famous for having the self-assigned job of taking away the punch bowl just when the party starts getting really good, would be sympathetic to those in trouble. But sometimes decisions are made that lead to bad outcomes, and it will often be better to let private markets sort out the consequences.

On the other hand, cries for help deserve a sympathetic response from the central bank when the underlying problem is macroeconomic or systemic. Let me briefly expand on that point.

The panelists have been asked to consider how central bank actions relate to financial instability. I think we can all agree that financial instability is bad, financial stability is good. More specifically, I think we can

all agree that we expect our economy to channel funds efficiently from households and firms who wish to save to households and firms who wish to invest. Our expectation is that the pricing of loans or assets involved in such lending appropriately reflects risk.

If the economy's ability to channel funds in this fashion becomes impeded, and funds from lenders cannot be channeled to creditworthy borrowers, at an appropriate risk-adjusted price, then, that is, well, bad. That's what I call financial instability. And the central bank should do something about this sort of financial instability — that is, financial instability that is systemic, economy-wide, and is manifested in widespread clogging of channels that move funds to creditworthy borrowers. By definition, such general drying up of credit implies some sort of macroeconomic, economy-wide dysfunction.

A mandate to respond when credit dries up may not, or may no longer, be given pride of place in central bank legislation in various countries. But insofar as central banks are charged with promoting employment or growth or some other measure of real activity, central banks are de facto charged with promoting financial stability.

How can central banks promote financial stability? A central bank can serve as lender of last resort. A central bank can inject liquidity. And a central bank can promote financial stability by lowering nominal interest rates. Low nominal interest rates on federal funds (to take the U.S. example) can serve to shift down the level of interest rates on various assets quite generally. That will cut back on credit rationing through mechanisms that have been well explored in the academic literature.

But doesn't this protect some private investments that otherwise would fail? And, if such a policy comes to be expected, doesn't it encourage risk-taking behavior? My answer is: I should hope so. Households and businesses of the U.S. and other countries *should* expect government institutions, including the central bank, to provide a financially stable environment. And as a consequence, during normal stable times, loans and investments will be made that would have been priced out of the market in an alternative, hypothetical economy in which there is a central bank that is not willing to work to ensure financial stability.

Many commentators — which, in the U.S. context, include both those who fault and those who laud the Fed for responding to what the Fed views as financial instability — draw on an analogy with insurance, likening the work of a central bank vis a vis financial stability to that of an insurance firm. As is obvious, I side with those who use the analogy to argue that central banks should respond to financial instability. The payoff from an insurance firm to a legitimate claim does indeed make whole an entity that would otherwise take a hit. And the existence of insurance no doubt encourages some risk-taking behavior. Some people who are a bit shaky when driving at night or in

poor road conditions might stay at home if they did not have insurance to protect them from some of the consequences of an accident. And so car insurance no doubt indirectly leads to an increase in accidents. But surely that doesn't mean we ought to prohibit or abolish auto insurance. Instead, we need to accept that an inevitable byproduct of insurance, including a commitment by a central bank to provide a financially stable environment, is an increase in risk-taking behavior. We cannot fine-tune our auto insurance, or our monetary policy, to the point that we insure only against risks that would be taken in a world without informational or other frictions.

In this as in everything in policy, the devil is in the details. I have expressed the view that in principle the central bank should stand ready to lower interest rates as one possible tool to help restore financial stability. In practice, there is the question of when and how much. Recent interest rate reductions by the Fed might — or might not — lead to a bout of inflation in the U.S. so severe that, with hindsight, less aggressive interest rate cuts might look preferable.

I'll leave analysis of that to my fellow panelists.