Kohn *Comments*

Donald Kohn

The former Federal Reserve vice chair, and potential next chairman, sat down with TIE *editor David Smick to talk about the world.*

Smick: Looking at the financial crisis from a global perspective, governments in their rescue operations during the last four years have spent $15 trillion, and central banks have expanded their balance sheets by around $5 trillion. Yet global growth recovered only modestly and is now starting to slow. Are monetary and fiscal tools no longer working?

Kohn: It's hard to say whether the tools aren't working as well as expected, or whether the problems they are trying to fix are extremely difficult. Globally, fiscal and monetary authorities are working against some very difficult headwinds. There was the buildup of debt—especially in U.S. households and European periphery countries—along with the compression of spreads and the rise and then collapse in asset prices.

And we didn't go into this with a huge amount of space in fiscal and monetary policy. Interest rates weren't that high in the United States—5.5 percent—when we started the slide into crisis in the summer of 2007, and we had dissipated our fiscal space with tax cuts in the early 2000s. Greater fiscal stimulus might have been appropriate, but already-rising debt levels when the problems began made it much harder to take more aggressive action.

Smick: Twenty years from now, will historians say that what happened in response to the financial crisis was an organized elite effort to preserve asset values that were simply not sustainable? The theory goes that this fool's errand has now saddled future generations with horrendous debt and a dangerous monetary overhang. Any validity to this charge?

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Kohn: No, that wasn't the purpose of the response to the crisis. Rather it was to prevent a very bad situation from becoming worse—a downward self-reinforcing spiral taking hold, inflicting more damage than would be required by the needed correction in asset prices. In fiscal policy, it wouldn't make sense to jeopardize future generations with debt trying to preserve a particular level of asset prices. And some fiscal efforts, like the TARP funds applied to banks, were repaid with profits for the taxpayer. The monetary and liquidity policies of the Federal Reserve were classic panic-stopping liquidity provisions and attempts to limit the downward slide of the economy and promote expansion. To be sure, one channel through which monetary policy works is by bolstering asset prices, but I very much doubt that anyone at the Federal Reserve wants to restore the house prices of 2006.

So I don't think it was an effort to return to the bubble levels of asset prices, but rather to cushion the effects on employment and output of the decline in asset prices and the tightening of credit. A series of headwinds have hit the economy since then, including from Europe, which we certainly didn't anticipate going into its own crisis when we were fashioning policy back in 2008. In addition, fiscal policy has moved toward restraint as we have gotten past the immediate crisis response. In the U.S. economy, that fiscal restraint is occurring at the state and local government levels as well as with the federal government. Moreover, spending is being held back by a tremendous amount of uncertainty that revolves around U.S. fiscal and regulatory policy. How much is the health care act going to cost? What will that do to business incentives to expand? What will be the taxing and spending policies of the government next year? A huge amount of uncertainty seems to be weighing on business sentiment in particular, and businesses are sitting on piles of cash, waiting. We haven't done anything really to alleviate that uncertainty, especially in the area of U.S. fiscal reform, except kick the can down the road.

Smick: But around the world, private and public debt has now reached an incredible 350 percent of GDP. What does this mean for the future of the world economy?

Kohn: I agree, the debt overhang is a problem that will need to be worked off very gradually; a recovery of GDP to much closer to its potential would help, but servicing that debt when interest rates rise is going to be burdensome for debtors, even as it is net income for creditors.

But let me back up to your earlier question about policy effectiveness. We need to be careful about asserting that the aggressive actions haven't had any effect. One of the really hard things for government officials and economists to convince people of is the counterfactual. Compared to what? What would have happened if these actions hadn't been taken? In my view, monetary and fiscal stimulus helped, but it is hard to prove by how much.

Smick: Is the Fed in particular promising more than it can deliver? And in the end, will the U.S. central bank become the scapegoat, the political whipping boy for an electorate frustrated by unmet economic expectations?

Kohn: It's trying to avoid that. Chairman Bernanke has been very clear on many occasions that monetary policy is no panacea. Many fiscal problems have to be fixed for the economy to rebound. And the Federal Reserve's own projections don't seem to envision big effects. For example, the Federal Reserve's projections after the recent QE3 went up by a quarter of a point for next year. Projected growth might have gone down without QE3, but we're not talking about a large effect. So I hope they're not perceived as overpromising. They see themselves as just doing what they can to achieve the goals that Congress has given them.

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Smick: But hasn't the Fed built up unwise expectations that QE3 is going to have a dramatic effect in reviving demand? The huge surge in demand failed to occur with QE1 and QE2. Why will QE3 be different?

Kohn: I'm not sure whether the expectation is that it will have a dramatic effect on the economy. I do think there's an expectation that they'll keep doing it until they can see faster economic improvement and they have fed that expectation by having open-ended commitments to purchase securities until the outlook for the labor market improves substantially, and to keep the fed funds rate at an extraordinarily low level even after the economic recovery strengthens.

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Building those expectations in has been a deliberate strategy on their part, and it's interesting that Chairman Bernanke both in the press conference and in his recent speech talked about the effect on confidence. They're hoping households and businesses understand that the Fed will be there at least trying to stimulate the economy, and they hope that builds confidence.

Smick: It is true that the Fed can prop up asset values in the short run, but can prices be sustained in the long run? Can the Fed prop up asset values long term without the underlying fundamentals supporting those values? Without adequate fundamentals, isn't there a risk of a series of new bubbles? When those bubbles burst, won't the disinflationary effect be debilitating? I've heard people at the Fed intimate that the bubbles won't burst because the Fed will just keep the QE policy going indefinitely. But doesn't that compromise the Fed as an independent institution?

Kohn: Regarding the channels through which this is working, a fair point would be that the effect of lower interest rates on stimulating spending by reducing the cost of capital has never been the strongest channel. For households, lower interest rates have somewhat offsetting income and substitution effects. But surely lower interest rates are helping a little, as one can see to some extent in the mortgage and real estate markets.

The wealth effect is important, and it's working not only on equities but also helping to turn around housing and limit the losses people are taking. And don't forget the exchange rate channel. The dollar exchange rate is at least a little weaker than it otherwise would be. U.S. exporters and companies that are competing with importers are probably better off than they would have been if the Fed hadn't taken action. And to the extent that U.S. actions are inducing other central banks to ease, that's probably helping the global economy at this point.

Finally, there's the credit channel for businesses that's become unclogged; credit seems amply available to many businesses, especially those with access to the securities markets. For households, credit is more freely available for many uses, though unclogging is just beginning in the residential real estate sector. It's no accident the Fed targeted their recently announced purchases on mortgage-backed securities, hoping to make credit in the mortgage market not only less expensive but able to flow better.

What are the costs of these actions, and are they distorting asset prices? They're surely distorting Treasury bond prices. Raising the prices of government bonds will cause people to diversify into other bonds and assets. To some extent, that type of distortion is an objective of policy—how it is transmitted to the broader economy. Whether the distortions are more widespread and what will happen when the economy strengthens and rates move up are open questions. But asset prices and the wealth effect are only one of several channels through which policy is thought to be acting.

Smick: Isn't the wealth effect usually associated with the stock market? As stock prices are pumped up, affluent investors feel even more affluent. They go out and buy things. But here's the question: How many flat-screen TVs and fancy sports cars can Mark Zuckerberg buy?

Kohn: Most people looking at the current level of the stock market don't think it's substantially overvalued. I'm certainly not an expert on that. Chairman Bernanke has said the Fed is watching these things carefully. But bond rates are definitely distorted, with negative term premiums. I completely agree that at some point when the economy comes back this is going to have to reverse, and that's going to be difficult and potentially messy, but it will be occurring in the context of a stronger economy.

Smick: I applaud Chairman Bernanke's creativity and willingness to try new policy approaches in 2007 and 2008 in the face of financial collapse. Yet government officials do not have a great track record of targeting asset values. That's because it's very tough to know when something's overvalued, when a bubble is forming, when irrational exuberance is popping up, versus a scenario of real increases in asset values. To what degree are policymakers engaged in policy hubris when, in fact, some humility is in order?

Kohn: I agree that it's very difficult to spot a bubble forming, and I'm a strong advocate of humility in policymaking. I suspect they're somewhat focused on the level of asset prices but also on the amount of change, so they're trying to raise equity prices, and when they decide to begin exiting from these policies, it will be in the context of a stronger

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economy. Although bond yields will rise, it's a little hard to tell what's going to happen to other asset prices such as stock prices and junk bond spreads under those circumstances. From a financial stability perspective, the most important asset prices are in the real estate markets and those don't look bubbly at this point, nor do I think the Federal Reserve is trying to inflate those prices above their fundamentals.

Smick: I can't resist asking this question. The Bernanke Fed takes credit for creating two million of the four million or so American jobs created since 2009. President Obama claims credit for the whole four million. Which claim is correct?

Kohn: It's a cute question and I have no idea what the percentage is. Of course the president's going to claim credit for everything that happens on his watch, just as he gets blamed for everything that happens on his watch. I do think monetary policy contributed to job creation. I don't know whether it contributed two million jobs. When Chairman Bernanke gave that number he aggregated the effects of the various QEs and used models to make the translation into jobs. The models—like the rest of us—have never lived through a period like this, so we wonder how accurate they are. It's fair to say the Fed contributed to the increase in jobs. Exactly how many is impossible to say.

Smick: You, Chairman Bernanke, and others at the Fed at the time deserve enormous credit for moving quickly to supply ample amounts of liquidity in the early stages of the financial crisis.

Kohn: Right. We took quick action, starting in the fall of 2007 with the discount window and into the spring of 2009 with purchases of mortgage-backed securities and Treasuries.

Smick: You quickly took the prospect of another Great Depression off the table. Yet the question now among global bond investors ironically is whether the Fed can be trusted. It's been suggested that of the two major central banks in the world—the European Central Bank and the Federal Reserve—the ECB looks to be the prudent one. Is that why the euro, despite a collapsing eurozone economy and all the other problems, continues to remain relatively strong against the dollar? If you were a trader in foreign exchange, with one central bank intimating a QE policy forever and the other calling for bond buying but with conditionality, which central bank would you trust?

Kohn: The European Central Bank is facing a very different problem than the Federal Reserve. There's some overlap because the ECB is facing a weak economy on a eurozone-wide basis, so they need to stimulate. But the issue of what's happening to particular constituents within the system is not one that the Fed faces. What ECB President Mario Draghi and the ECB did by linking their support for individual countries to the conditions set and agreed by the politicians was a very smart thing to do. But it wasn't as if the Federal Reserve went in and bought California bonds, making California debt the obligation of all the states. I'm sure that the U.S. taxpayer would want conditionality if that were the case. In the past when U.S. taxpayers have come to the aid of individual cities such as New York and the District of Columbia, they imposed strict conditions. They're facing a different set of issues in the eurozone, and making an appropriately different response.

It's very difficult to spot a bubble forming.

What you're getting at really is the inflation credibility of the institutions. So far, I don't see much erosion in the Fed's credibility. There hasn't been any substantial change in the long-run inflation expectations of households or worries echoed in the markets. If I look at the five-year, five-year forward inflation premium embedded in nominal bonds, which is what the Fed follows very closely, there was a bump after the last announcement, but some of that has reversed. Those inflation premiums are at the top of, but still within, the range they've occupied for some time.

I can remember in the spring of 2009 after the first action, I attended a couple of conferences on college campuses—Stanford, Princeton, Vanderbilt—and I was challenged by people who put up slides showing the projected Fed balance sheet and said, "We've never had an increase in the base like this without having inflation." That was three and a half years ago and inflation has remained quite tame.

Smick: I agree. Historically, it is hard to have inflation with such weak labor markets. Yet shouldn't central banks be careful anyway? In July of 1977, for example, the thirty-year Treasury bond was yielding the same as it was in July of 1970. Inflation was thought not to be on the horizon. Yet by the end of 1977, price levels began to soar and the rest is history. Isn't the ultimate danger for the Fed a deep-seated policy overconfidence bordering on hubris? After all, policy-wise we seem to have entered uncharted waters.

Kohn: I agree we are in uncharted waters and humility is called for. The Federal Reserve will have to exit at some point, we hope, because the economy will be stronger. The exit will be difficult. It could be kind of messy. There are a lot of steps to take. Number one, stop buying. Number two, raise the interest rate on excess reserves. Then start absorbing reserves and selling assets. There are many steps, and there will be market reactions at every stage of the process.

Smick: A lot of people worry about the Japanese lesson. Japan faces a bond market trap, making a vigorous recovery all but impossible. That's because Japanese ten-year government bonds dominate every public and private balance sheet, particularly the balance sheets of the banks. Therefore, Japan by definition can't have a vigorous recovery without facing an immediate banking crisis. Japan, Inc., would face a downward mark-to-market of its collective balance sheet because of massive bond losses. Could the United States find itself in the same predicament?

Kohn: We lived through a pretty rapid increase in long-term rates in 1994. Some hedge funds went out of business, some people took losses, but in fact the tightening in 1994 set the stage for five more years of good non-inflationary expansion in the United States. Raising rates really didn't undermine the expansion. I know that the supervisors have been taking a careful look at the interest rate risk of the banks and warning them that some day rates will go up. The concern is less about the big banks and more about the small- and medium-sized banks who might not have the risk management capability of the big guys.

Smick: And they've already been hit by the Fed's manipulation of the yield curve, which has been good for Wall Street but devastating for the small- and medium-sized banks.

Kohn: Yes, interest margins are down because the banks can't reduce deposit rates below zero and their earnings on assets are limited by low market rates.

Smick: Bill Gross of PIMCO said the United States is like a budgetary crystal meth addict. I don't know much about crystal meth addiction, but it sounds bad. Has the Fed abetted the debt situation? Have the Fed's monetary policies given Congress and the Administration a free pass, removing the requirement of budget discipline? When you look back, for example, at Paul Volcker's time, Volcker seemed to talk more about the debt than he did about monetary policy. He was the debt conscience for Capitol Hill. To a certain extent, Greenspan at least tried to perform a similar debt-brake role—no monetary candy without fiscal discipline. Today the candy is limitless and seemingly with no strings attached.

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Kohn: I don't agree with that. Bernanke's been quite strong in preaching to the U.S. Congress that the United States has a long-term debt problem they need to address. In his Budget Committee hearings and monetary policy hearings, he's hit that theme pretty hard.

Smick: Maybe it doesn't seem as threatening as when Paul did it.

Kohn: Well, Bernanke's not as tall and he doesn't have a cigar. And I don't know how much influence Paul Volcker really had, given the huge tax cut President Reagan did when his administration came in.

At that time there were a lot of more centrist legislators who recognized the issue and were willing to take action, including higher revenues, to deal with it. Also recall there was Gramm-Rudman-Hollings, which was an expression of "We've gotta do something," but never was very effective.

Smick: Reagan did agree to the TEFRA tax hikes in the early 1980s. In the past year, Chairman Bernanke has talked about the risk of tightening short-term fiscal policy too soon with demand so weak. Fair point. But why wouldn't the chairman have been more of a champion of entitlement reform? That would have been a very powerful statement to global markets that Washington is intent on creating a climate of fiscal discipline in the long run.

Kohn: No one seems ready to do the compromising they know they need to do. One of the accusations I hear is that the Fed is facilitating Congressional irresponsibility by keeping those rates so low. Congress isn't getting the market signals that they were getting in the early 1990s when Treasury Secretary Bob Rubin could argue, "You will be rewarded in the bond market for doing the right thing, and that reward will then help investment and home ownership." That's not possible to argue now.

But the legislators and the president—I put the blame on both—know what they need to do. They know they're bequeathing problems to their children and grandchildren. They know they're risking a credit rating downgrade and a loss of confidence that the political process in the United States will do what needs to be done to meet our obligations. Our policymakers shouldn't need higher interest rates that will then throw people out of work. How many unemployed people do they need to see before they do the right thing?

Smick: Some people think the debt has had a Ricardian equivalence effect. The debt is a disincentive to affluent consumers, who are responsible for half of consumption, because of a fear of higher future inflation, taxes, or both.

Kohn: I don't think people are holding back on consumption because they their think taxes will be higher in ten or fifteen years. I don't get that sense.

Smick: Obviously, the average person doesn't follow the issue closely. But affluent consumers at the top seem to have an acute awareness of the massive debt. The same with business investors who express uncertainty about the fiscal and monetary future of the country. They too seem to be holding back. If the debt entails no threat to the economy as some are arguing, why not raise the debt to five times GDP as a growth strategy? Let the Fed buy the bonds indefinitely.

Kohn: Yes, and people certainly don't like it. They want something to be done about it. But when you get down to the specifics, then they become somewhat reticent. Cut waste, fraud, and abuse from the government budget, they say, but not my Medicare and not my Social Security and don't raise my taxes. The U.S. savings rate is still pretty low, which doesn't suggest to me that people are saving more now because they're concerned about taxes later in a Ricardian equivalence kind of way. The uncertainty may not be contributing to households holding back from spending very much, but I think it is contributing to a lack of confidence by businesses. The slowdown in investment spending over the last few months has been quite marked. It's a very worrisome development.

Smick: Sheila Bair, the former chair of the Federal Deposit Insurance Corp, in a new book talks about the Obama Administration's soft handling of the big Wall Street banks. Any regrets that there wasn't a tougher approach to Citi and some of these other banking dinosaurs that are now too big to fail? They are quickly becoming like large public utilities, more worried about their own survival than about financing an American economic renaissance.

Kohn: The too-big-to-fail banks remain a big problem. I certainly regret that we weren't tougher on them in the years leading up to the crisis so that they were in better shape when the crisis hit. They wouldn't have been as exposed and vulnerable. Some banks were not in good shape when the real estate market turned down, and some purchased problems by absorbing thrifts, but a lot of the real problems originated outside of banking, such as Bear Stearns, Lehman, and AIG. So yes, banking regulation could have been better, but the blame should be widespread.

Smick: Should these large institutions be broken up?

Kohn: I agree with Bair that too-big-to-fail banks are still a problem. I agree with Dodd-Frank and Basel III and the Financial Stability Board that when you're classified as too big to fail, you need to be much better capitalized with much more liquidity. You need good risk-management systems supported by comprehensive management information systems to know what the heck is going on in your institution.

The too-big-to-fail banks remain a big problem.

Imposing those extra requirements on those guys might not cause them to shrink, but they won't grow as fast as they otherwise would.

I'm not sure that breaking them up would make the system that much safer. Bear Stearns and Lehman weren't very big. People argue that the repeal of Glass-Steagall caused the crisis, but I don't really see that connection, given what happened. We need to think carefully about where we are going. The U.S. and global communities of regulators are trying to get rid of too big to fail through various means, and breaking them up may not be the best answer.

Smick: Isn't the problem that today's big banks are experiencing a brain drain? As a result, they are increasingly less equipped to evaluate risk for investment in the future of the country. Agree?

Kohn: Some of that riskier stuff will probably migrate to other parts of the financial system, and that's all right as long as those parts are able to fail without bringing down the global system. Money market funds are another institution that failed and threatened to bring the system down. They weren't part of the banking system, but served as an important source of its funds and funds for the so-called shadow banks that held mortgage-related obligations.

So I'm not in the break-up-the-big-banks school, but we should make it almost impossible for them to fail and when they do fail, the resolution regime should make sure that there are senior creditors at risk who will take the hit and recapitalize the systemically important pieces. Institutions can be resolved without endangering financial stability. We just didn't have the tools last time. Whether we have them now we won't know until the next crisis.

Smick: In my view, financial market lawyers are too clever for the regulators regardless of how carefully regulations are written. The markets will always figure a wily way to skirt the rules. The only way to keep the Wall Street banks from doing really stupid things is to raise their capital requirements. Whatever the regulatory constraints, the bankers are going to figure ways around them. Agree?

Kohn: I agree with you about the need for more capital, more liquidity, and more safety, which would make these institutions more like utilities. That would be okay, provided there's innovation going on somewhere in the financial system, and the financial system still converts savings to investment and distributes risk efficiently.

Smick: Bill Clinton's political adviser James Carville used to joke that if he believed in reincarnation, he would like to come back as the bond market. You are all-powerful in dominating policymakers. But Carville was wrong. He should have asked to come back as a big bank, particularly a large European one. No matter how badly you screw up, the central bankers will come in and protect you when you ought to have been ruined through your own stupidity.

Kohn: Although the bankers who led these institutions into trouble were fired or quit, they maybe didn't take the financial hits they should have taken—though their shares and options ended up almost worthless in many cases. If you were a shareholder in Wachovia or Bear Stearns or AIG or Citi, you don't have much to show for it. The shareholders of the troubled institutions took huge hits. The creditors were protected and that's what we've got to fix.

Smick: Is the globalization model about to experience a crackup? In the last six months, global trade growth has plummeted. The eurozone banks were major sources of emerging market capital and now that capital is returning home. Is the world at a great turning point? The Doha Round's dead, and the entire global trading system is pulling back. The Petersen Institute says more than sixteen countries in addition to China are currency manipulators. If globalization is cracking up, what's the new model for global growth?

The crisis revealed very severe strains and cracks in the global financial system.

Kohn: It's a worrisome trend. The globalization of markets for goods and services, while inflicting pain in some places, increased global growth tremendously for a while after the fall of the Berlin Wall and the realization in China and in India that markets could be engines of growth. One of the terrific things that has happened over the last ten or fifteen years is literally hundreds of millions of people came out of poverty in China, Asia, and South Asia. The process isn't complete, but a lot of that happened on the back of global trade.

The crisis revealed very severe strains and cracks in the global financial system. I was pleasantly surprised that there wasn't more regression with respect to trade protectionism. During the depths of the crisis in 2008 and 2009, I expected many more trade barriers to be erected given the severity of the recession. It's to the credit of the Administration and all our trading partners that although progress in the Doha Round is stalled, the amount of backsliding has been pretty limited.

But given the strain on the global economy, I do worry that the quantity of global trade seems to be shrinking. I think that's a product of the strains on global economies, and I hope that as they begin to turn around, trade will pick up again. We need to fix the financial markets and address those vulnerabilities globally. We have empowered the Financial Stability Board to take a more robust global role and that's good. Nations still need to implement agreed-on financial reforms. Ideas are moving in the right direction, even if the implementation isn't there yet.

Smick: I respectfully disagree. Many parts of the world are looking more inward than before. The G-20 gatherings of the world's most economically important nations in the last year increasingly have looked like little social gatherings with no real policy purpose. The house is burning down and the G-20 is having tea in the parlor.

Kohn: It could be very dangerous if this recent economic weakness does induce regression in the global trading system, or finance issues continue to be a problem. In the middle of the crisis, 2008–2009, it was very clear that trade finance had dried up along with every other kind of finance. The Federal Reserve's swap agreements helped keep dollars flowing through the system when the private markets couldn't do it. That may not be necessary anymore, but the banks need to support trade, and global financial institutions need to help globally distribute capital more efficiently. They create risks, but also more rewards. I worry about the increase in home bias. With any luck, what regression we've seen is a consequence of the current business cycle, and once we begin to come out of that, things will get better.

Smick: Let's hope so. Thank you very much. ◆