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First he rose to become the Federal Reserve's top staffer. Now he helps set the pace as one of Washington's newest Fed governors. TIE*'s exclusive interview with Donald Kohn:*

The Conscience of the Fed

Fed Governor
Donald Kohn.

TIE: How have you found being a Fed governor different than being a member of the senior staff?

KOHN: I've enjoyed the transition. I was ready for it; I had worked on monetary policy issues particularly during the last fifteen years, and I was ready to diversify my portfolio into other things. I have become involved in payment systems issues, internal governance issues, and representing the Fed before international bodies such as the Organization for Economic Cooperation and Development. I've also liked the change in perspective from preparing the materials to having responsibility for the decisions that are made. Now I try to convince other people, and I realize people are going to look at how I vote, and I will need to take responsibility for how things turn out.

TIE: Has this changed your relationship with Fed Chairman Alan Greenspan?

KOHN: To some extent. I don't interact with him as frequently as I did when I was a staff member and he would call me for specific information anywhere from three times a week to three times a day. But I've maintained a nice back-and-forth relationship with him. I'm very comfortable exchanging views on the economy and the appropriate stance of monetary policy. I'm no longer involved in the preparation of his speeches and his testimonies, and that very intense working through of the details.

TIE: Who replaced you as director of the monetary affairs division at the Fed?

KOHN: Vincent Reinhart, who's very good, and very smart. He's much more tooled up in very recent economic and financial research. He's also taken over the responsibility of secretary of the Federal Open Market Committee, and the division is flourishing under him. It gives me a lot of pleasure to see the division that was created for me—my baby—grow into adolescence and survive and thrive under new leadership.

TIE: Let's begin with a general question about the transmission of monetary policy. How difficult is it now, with interest rates so low and the prospects of disinflationary pressure increasing? What concerns do you have that you didn't have in the past?

KOHN: My concerns aren't about the transmission of monetary policy right now. The same transmission mechanisms have been at work over the last few years. We've seen lower interest rates feed through to the housing markets and to support consumer spending. To some extent the lower interest rates have kept the equity markets from falling quite as much as they might have. They've helped households and businesses rebuild their financial strength and get ready to support greater spending in the case of businesses and actually support spending in the case of households, especially the mortgage market and the mortgage refinancing process.

The lower interest rates have probably contributed to the dollar's decline, which will feed through over time to stronger exports and strengthen total demand in the United States. So far, the fact that the federal funds rates have gone all the way down to 1.25 percent hasn't impaired the transmission of monetary policy.

Our problem so far has been the deficiency of demand. Businesses in particular, despite a very low cost of capital, don't see a lot of profitable investing opportunities, at least as much as in other expansions. Monetary policy has already had to try to bolster household demand to make up for the lack of business demand.

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TIE: Well, at some point you move into the non-traditional policy, which is uncharted territory for the Fed.

KOHN: That's right. We still have some room in our conventional monetary policy, whether it's all 125 basis points would need to be examined, but a considerable amount of space in any case, and I expect that to work through markets the way it always does. If we go through our conventional policies, we'll need to think about other ways of stimulating the markets. A couple of channels might work to bring down long-term interest rates, including an expectations channel. We can convince people that we intend to keep short-term interest rates low for quite a while.

TIE: A lot of people saw your hand in the Chairman's recent efforts through public statements to initiate a kind of verbal ease. Are we seeing the beginnings of "virtual monetary policymaking"?

KOHN: I wouldn't take credit, but I thought it was effective, and that's a good example of how the FOMC can still bring down longer-term interest rates using a combination of words and actions. It was primarily a case of giving people information that led them to push off the time at which they thought we probably were going to tighten. Should we begin to exhaust conventional policy actions, our words will become all the more important. They will have to describe how we see the situation and what we're looking for in terms of the economy, allowing inferences on how long we intend to keep policy in a very easy mode. Then there'll need to be actions that will back up those words.

The other channel through which monetary policy can work in such situations is what people call imperfect substitution—just buying a large amount of assets,

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whatever they are, and affecting the relative supply and demand for those things and hence their price.

TIE: Would you take a neutral approach to buy various securities as you move out the yield curve? Or would you start at the short end or immediately move to the long end?

KOHN: I actually haven't made up my mind. This is very much a work in progress, and we are studying this question right now. This subject has come under intense discussion both publicly and within the Federal Reserve, and as the possibility has drawn closer, my ideas on these issues have changed over time. It's not something we've dealt with before. The Japanese experience gives us some pointers on what not to do, but we will probably make our own mistakes as well. I can see arguments for buying along the yield curve. I can also see arguments for working out the curve to help convince people at least for the near term that we're going to keep interest rates at a very low level and let that feed through. There are arguments pro and con for just setting a rate at a two-year level, for example, or doing a lot of buying and letting the market sort it out to a certain extent.

One of the lessons I take from other countries' experience is to think about these things ahead of time and have a plan, obviously subject to revision. We should have some conviction behind the plan and have good public communication about the plan's general scope. We can't say exactly what we're going to do, but we ought to be able to tell the public the options we're considering and why we think they would be successful so we don't appear to be lurching into an emergency situation.

TIE: Most people at the Fed, in public speeches and testimonies, seem to be describing a kind of jobless recovery. Many years of extraordinary productivity performance is probably going to continue in some form. It's not going to be a feel-good period during an election year for George Bush. To what extent do you worry that this jobless or even job-killing recovery becomes a factor to the consumer, who's kind of been the hero in this whole process particularly since September 11? If the United States hits a high-enough growth rate, will the jobs issue stop having a dampening effect for the consumer? Is 2 percent GDP enough to move you out of the woods? Or do you need a global growth rate closer to 4 percent?

KOHN: I don't know of a specific number here, although productivity growth in the United States should remain faster than it was from the mid-1970s to the mid-1990s. This productivity growth is a net plus over the longer run, but it means we need more demand growth to use up this higher potential. So far consumer spending seems to have been robust to the fact that the labor market has been weak, and in fact has weakened

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substantially since last summer. My expectation is that the employment situation will improve.

I don't necessarily agree with your assessment that next year will be a bad year for the labor market.

Growth will pick up, though how fast I don't know. Many of the things that have been weighing on the U.S. economy have eased. The effects of the excesses of the late 1990s—in capital spending, corporate governance, and bad credit decisions—are further behind us. The equity markets have leveled out or come up just a little, and the negative effects of the decline in wealth are further behind us. The geopolitical risks are alleviated to some extent. Oil prices are down from where they were. There are a lot of reasons to think that growth will strengthen from this 1–2 percent growth track we've really been on since last summer. The question is how much.

The consumer has supported this expansion, helped by low mortgage rates and low interest rates on automobile purchases. General Motors wouldn't have been able to offer zero rates on car loans if the general level of interest rates had been much higher. Consumer confidence has now recovered after the Iraq war. It's not high, but it's recovered. As I already noted, household spending seems to have been reasonably robust to the soft labor markets. Household savings rates have risen gradually and that's what you'd expect as wealth comes down. I wouldn't be surprised to see a further gradual rise in household saving. That's good—it means that they're rebuilding their balance sheets. Over the longer run, household saving will replace some of the saving that the government used to be doing and isn't doing anymore. As our current account balance turns around as a consequence of the dollar decline, a gradual uptrend in household saving over time is very desirable to help fund capital spending. Household saving could begin to spike if households become very worried about the labor market and that's a risk. But, as I already noted, I'm encouraged by the fact that it hasn't happened so far despite months of pretty weak labor markets. I don't see this as a knife edge—all of a sudden households will wake up one morning and the desire to spend will be gone.

TIE: Chairman Greenspan has implied that some of his confidence is based on getting to the point where capital replacement becomes a big issue. Are CEOs acting rationally by saying, "OK, I've got to invest for replacement purposes"? Are they so afraid of their boards that they can't even do that?

KOHN: Capital replacement will become an increasingly important issue. Some of the weakness in investment we've seen over the last few years results from a stretching out of replacement cycles. If that stretching out stops, gross investment will begin to pick up. In addition, new technologies are coming online here, not "killer aps," but an accretion of changes which means those old computers are increasingly out of date. We've actually seen some strength in the high tech area outside of telecommunications in the capital goods orders and in the industrial production index. Purchases of computers and peripherals are beginning to pick up and that's replacement demand kicking in. That's going to bolster things. And I don't think caution by boards of directors will stop that from happening. This is a case of keeping their current plant going and maybe doing a little bit of modernization.

People never should have expected the sharp V-shaped recovery some were talking about in 2001.

TIE: Isn't timing an issue? Will capital spending really kick in this summer, or will CEOs just hold off for six months and write off 2003? No corporate board is going to jump on a CEO for being cautious in this environment where they might have a couple of years ago.

KOHN: A key to the outlook all along has been for business investment to begin picking up to supplement the increase in consumer and government spending that's kept the economy moving. I'm hoping that as the intensity of the corporate governance worries and geopolitical risk problems abates, some of the natural resilience of the economy begins to show through and we see more capital investment. The cost of capital is low; final sales although sluggish have been increasing. Yes, capacity utilization is very low, but remember capacity utilization is only in the manufacturing sectors, a small part of the whole economy. And we've had a pickup in investment before when capacity utilization has been low. It's a question of confidence in the future, and I'm hopeful that business confidence

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will regain some footing and be more forward-looking despite caution arising from a reaction to corporate governance concerns.

TIE: Consider this analogy. When you look at markets—say currencies or bonds—and see a massive short position that's clearly oversold, sometimes after a while, two or three traders will get together and one will offer ten reasons why he's now suddenly going the other way and reversing his trade. Suddenly it's a stampede. Other traders may not fully agree, but they've got to square up and get back to neutral if simply to preserve profits. Could we face a similar situation in corporate board rooms? If some more optimistic CEOs actually go public, could they incite a stampede in terms of capital spending? No one wants their board to ask why the company stayed behind and lost market share if the capital investment side of the economy is about to take off.

KOHN: Right now we're in a situation where businesses are able realize a lot of efficiencies and do a lot of cost-cutting using capital they put in place in the late 1990s. The incredible growth of productivity through this whole period is a testament to the fact that that capital really was productive. Now, not only do businesses have the replacement issue staring them in the face, but they are running out of stored-up ways of cutting costs, and they'll be looking to buy new equipment with new technology that will help cut costs. That's a positive in the future. Over time the boards will ask how CEOs plan to increase profits, and the answer in part is by replacing the equipment that's there, by expanding capacity, and fighting for market share.

TIE: At some point, you've got to have well-trained human capital in place.

KOHN: People never should have expected the sharp V-shaped recovery some were talking about in 2001. There was obviously a lot of overinvestment in the 1990s. But this was a shallow recession. The expectations are logically different than they would be coming out of the 1982 recession, for example, where the economy was very weak and in the process of snapping back. A process of gradual strengthening is ahead. You can actually wait and make investment decisions as you see the strengthening happening. The conundrum is that if everybody waits to make those decisions, the strengthening won't happen. But we should see a kind of an erosion of this holding back and that could build on itself. I would not expect a kind of rubber band effect of a very sharp snapback in investment. We have a lot of capacity, probably in service industries as well manufacturing industries. There's no reason for people to expand capacity hugely, but it will be a process that builds.

TIE: The capital spending issue continues to be troubling. Private companies appear to be gearing up for expansion. But the public companies seem to be just as risk-averse as ever. Are the Enron debacle, the accounting issues, the liability question for corporate boards, and other corporate governance issues dampening the economic psychology among corporate decision makers?

KOHN: There's no question that corporate governance issues had an important dampening effect on business investment through the end of last summer and into the winter. If a business itself or even a competitor had a problem, there was the potential for a spillover in skittish financial markets. And the cost of funds to corporations went up even though interest rates were going down because of the decline in equity prices and rise in credit spreads. That aspect, however, has been alleviated to a considerable extent. Credit spreads are back down to below where they were last May and June. In many cases equity prices haven't recovered to their levels of last May and June, but they're certainly off the floor again. We've had several corporations in the past few months—HealthSouth and Royal Ahold are the obvious examples—that have reported problems and there hasn't been

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any contagion. The markets took it in stride. There's a lot more investor confidence in the transparency of corporations today than there was six or nine months ago. It's been a painful process but it's there.

Much of the dollar weakness seems to be channeling through Europe.

The other side is whether the fact of boards of directors worrying about later being found liable for what looks at the time like a risk worth taking isn't damping their enthusiasm for projects. Certainly the worry must be consuming their energy in ways that leaves them less time to think about business prospects. My guess is that it's now a small effect. If the economy began to gather some momentum, the optimism would begin to return to these corporate boardrooms—though not like in the 1990s and that's probably a good thing.

TIE: What are we to make of the narrowing of risk spreads? Is big-time recovery just around the corner or is the narrowing the result of frustration borne out of no returns on other instruments, and liquidity reaching for yield, and unsophisticated pension funds driven into that market reaching for yield?

KOHN: I've heard that also, actually more from market participants than people in the Fed. My view is that investors wouldn't be reaching for these yields if they thought they were going to lose their money. The situation last summer that wasn't all that different. The Fed funds rate was low and Treasury bond yields were relatively low, yet investors didn't feel the need to go reaching for yield then. They felt the need to pull back, to retreat to safe, lower-yielding assets. If they were really concerned about risk now, this wouldn't be happening. It's more than just greed overcoming fear. I think the fear has died down to a considerable extent.

TIE: Some people say mortgage refinancing has been another important part of keeping the economy going but unfortunately the system's at capacity. The industry says that they're thinking about charging higher fees if they have to go through another round of refinancing.

KOHN: Every time there's a peak, the mortgage companies say that the waiting lines are lengthening and they might even be raising fees a little. But it's become an extremely competitive industry. Technology has been very beneficial in allowing borrowers to compare rates and fees over the Internet, limiting the ability to raise fees. At the worst, longer lines would just stretch the thing out a little bit and that might not be all that bad. It shouldn't dampen the total very much.

TIE: We've had a weakening of the dollar, and yet the bond market has rallied. What do you make of that?

KOHN: Bond market investors are being driven primarily by perceptions of a dampened and delayed recovery in the United States and that interest rates will stay low for a while. The United States has a huge current account deficit. Everyone predicted that at some point that deficit will need to correct itself, at least in part through dollar decline, but the dollar stayed high and that point had always seemed to be pushed further away.

TIE: If the dollar was over-elevated before, the realization that rates aren't going up anytime soon should cause the dollar to fall back in line. But people also debate whether you should increase the money supply.

KOHN: Because we operate with a federal funds rate target, the money supply is entirely endogenous, and it has been rising pretty rapidly over recent years. The dollar's been falling for a while. But it fell from a very high level—one that rose through 2001, even as we were dropping interest rates.

If we can strengthen demand and the economy rebounds then I'm not concerned about a dollar crisis.

TIE: Former Fed Governor Wayne Angell was recently on CNBC criticizing U.S. Treasury Secretary Snow about his recent comments on the dollar. The problem with the criticism is that the bond market has not been troubled by the dollar's performance. Is there an argument to be made that weakening the dollar is a win-win situation—a weaker U.S. dollar will force the rest of the world to stimulate their economies, and so eighteen months from now we'll look back on this as a "way out" of a global stagnation scenario?

KOHN: The U.S. economy, acting in part through the strong dollar, has been the vehicle for boosting demand in the rest of the world since the mid-1990s. The United States, however, hasn't had the horses recently, and other countries have been relying on us to get them out of their fix. The problem in some countries like Japan is a very limited ability to react. And in many Asian countries where their currency is fixed to the dollar, policymakers see more risk from unfixing than from keeping fixed. They're benefiting from the drop in the dollar, but it does dampen the effect of this dollar decline for the United States. Much of the dollar weakness seems to be channeling through Europe, which has the only major currency that can float and where monetary policy has the room to move.

TIE: Many economists say the current large U.S. capital imbalance is a recipe for a dollar crisis and sharply rising interest rates. But in order to have a dollar crisis, if the United States is running around the global track at *x* miles an hour, parts of the world must be running around the same track at a faster pace. Do you see, in terms of rates of return, any evidence that the rest of the world is beginning to pick up speed?

KOHN: I don't. I agree with the premise of your question. One of the things limiting the extent to which the dollar's recent slide could possibly turn into a crisis is the fact that the United States remains—even with all our problems—a more favorable place to invest than many other industrial countries in the world. The only areas where investment is obviously more profitable are some of the emerging market countries.

TIE: But the liquidity isn't there.

KOHN: No. So if we can strengthen demand and the economy rebounds then I'm not concerned about a dollar crisis. In the second half of the 1980s we had a very sharp decline in the dollar, much sharper than we've had now, and it didn't really have adverse consequences for our financial markets.

TIE: All these other areas would need to be more attractive places in which to invest, apart from the argument about the dollar's status as the reserve currency, not to mention the security the United States offers with its political structure and rule of law.

In the first Reagan Administration, Treasury Undersecretary for Monetary Policy Beryl Sprinkel's philosophy of "benign neglect" ran the dollar up to unsustainable levels. When the dollar's value came down, investment potential in the United States was hardly destroyed.

KOHN: That's right. I think the decline in the dollar at that time created some difficult but not intractable, issues for monetary policy.

TIE: There was a lot more global demand…

KOHN: …and a lot more U.S. demand at that time, and we were only a few years removed from the collective memory of inflation in the 1970s. That was an issue the Fed had to wrestle with as they adjusted monetary policy to the rapid decline in the dollar. That's not an issue now. Inflation expectations are low; long-term inflation expectations are extraordinarily well anchored. They didn't budge when oil prices went up. I wouldn't expect them to move when import prices go up a little. The chances are small that the decline in the dollar we've seen will feed through in a destabilizing way, although no one—particularly a central banker—should be foolish enough to say there's no possibility of a destabilizing set of expectations building. Let the record show I'm knocking on wood.

Let the record show I'm knocking on wood.

TIE: If the world wants temporarily to be liquid and Europe is paying twice the money market rates as in the United States, it's no surprise global investors are warehousing liquidity if temporarily, but at some point you know the rates in Europe are coming down further.

KOHN: Direct investment and merger-and-acquisition type activities have died down all over the world through this period of very weak demand and declines in equity prices, and the geopolitical risk issue has contributed to the falloff in those activities. People are coming home, away from where they might not understand the risk or the political dynamics. The home bias in investment must be one thing that accounts for some of this dollar weakness. In these circumstances, a current account deficit in the United States can put some downward pressure on the dollar and upward pressure on the currencies that are issued by economies in surplus.

TIE: Is there anything positive you can say about Europe? Structural rigidities, the high euro, huge long-term demographic problems, labor inflexibility, a political inability to come to terms with what needs to be done…

KOHN: Europe faces a lot of very difficult issues. Germany in particular seems to be lagging in making real reforms to free up its labor markets and reduce the structural level of unemployment. It's so hard to get rid of somebody, businesses are reluctant to hire people. That's creating generations of younger people who haven't really had good jobs. It's a harmful social and economic choice that they're making. It is sapping the energy from the biggest economy in Europe, and it's spilling over to the rest of Europe.

The fiscal situation is very difficult as well. Europe has a much bigger demographic problem coming than the United States does so you can see why those countries would want to limit their debt-to-GDP ratios; their long-run fiscal stability is even more in question than that of the United States. At the same time those limits have obviously constrained their ability to run counter-cyclical policy. They say this constraint arises because some countries at the top of the boom chose to cut taxes and therefore they've lost the room to maneuver. That may be. But it's having an effect on the whole area. Finding a way through this thicket of adhering to medium-term fiscal discipline while allowing not only the automatic stabilizers but maybe even some deliberate counter-cyclical short-term fiscal policy to operate is very difficult.

Europe faces a lot of very difficult issues.

Bringing the Chinese into the global economy is a net plus for everybody, even if it creates discomfort in the short run.

TIE: Using the Taylor Rule, Germany today should have an appropriate short-term interest rate of less than 1 percent, and Spain's should be over seven percent. The ECB has had a difficult job of trying to form a common monetary policy. Soon the difficulties could increase with the addition of the new countries: Estonia, Latvia, Lithuania, Slovenia, Slovakia, Poland, the Czech Republic, Cyprus, Hungary, and Malta. Isn't this expansion a problem for Europe and also for the world economy? Europe today enjoys neither political cohesion nor the kind of fiscal integration that we have here in the United States. After all, the Stability Pact seems irrelevant if not a bit of a joke, to be frank.

KOHN: The monetary union was conceived as a precursor to political union and in that regard Europe's undergoing a very unusual experiment. Europe suffered through two very destructive world wars in the last century, and wants to move in the direction of preventing that happening again. But by doing so in this way, they have made their economic lives more difficult.

The combination of the Stability and Growth Pact and the lack of a real federal presence limits Europe's ability to redistribute income from areas that are doing well to areas that are doing poorly. Obviously there are dispersions of performance in the United States, but we have ways of dealing with them. Europe needs to find a way to loosen near-term constraints on fiscal policies while maintaining medium-term discipline. The accession countries won't make the job any easier, because as their productivities rise, the natural tendency is for their real exchange rates to appreciate. If the accession countries are tied into even the exchange rate mechanism, much less the monetary union, that will be felt in higher inflation rates in those countries as they catch up to the rest of Europe. It's a very good thing for the world and for Europe to have these countries catch up, but it's going to create more strains in the monetary union.

TIE: Is there concern about the deflationary impact from China? China is essentially to the global labor market what Saudi Arabia is to the global oil market: China has zero marginal cost of labor. It accounts for 5 percent of world trade now but it has the potential to set the pace in the future.

KOHN: Bringing the Chinese into the global economy is a net plus for everybody, even if it creates discomfort in the short run in some industries that now find themselves with a tougher competitor than they had before. Certainly, it's a net plus for the people of China. Literally billions of people now have the chance for higher standards of living. India is looking at China and thinking, "Maybe some more market-oriented policies would be beneficial for our country, too," and it would be a major gain if they lift the hand of government from their economy as well.

The Chinese have a tough row to hoe. They're trying to do something extraordinary, which is to keep political control while they let go of economic control. Whether this will actually work—whether this is stable in the end—remains to be seen. The emergence of China as an economic force does create issues for manufacturing firms and their workers whose processes are in effect being transported to China. But it's an opportunity as well. It's an opportunity for workers in the processes that migrate to China to move up the knowledge chain, and get more productive jobs. There's a lot the U.S. economy does comparatively better than almost any other economy in the world, and if we can train our workers in these industries, everybody's going to be better off in the end.

When to free the RMB is a tricky issue for China. A lot of capital is trapped in China that might want to get out in the near term if capital flows were deregulated, and China is in the process of major changes in the structure of its financial markets and of industry as part of its entry into the World Trade Organization. The WTO has had a positive effect on the Chinese economy and to a lesser extent on Chinese financial markets. Yes, China is accumulating reserves, and that tells you that the currency probably would appreciate if it were free to move, but there are a lot of cross currents in play. They'll have to free it at some point, but the question is what the best way to do it might be. Right now China isn't a major deflationary force in the world. The rest of the world ought to have the tools in their tool kit to counteract that deflationary force.

The U.S. economy, acting in part through the strong dollar, has been the vehicle for boosting demand in the rest of the world since the mid-1990s.

TIE: You get a knock on the door, and it's President Bush and Chairman Greenspan. They have a job you can't turn down: Fly to Iraq and create a central banking structure, and by the way, in a few minutes or less, tell us what you're going to do. What would you tell them?

KOHN: I would concentrate on creating a stable and trusted currency and building up the banking system. The Iraqi currency problem is obviously foremost. This is a society that operates on currency, and you've got to figure out which currency to use, make sure there's enough of it, and facilitate market transactions by building confidence in the medium of exchange. You need a stable medium of exchange to encourage market transactions. Iraq now has several different kinds of currencies in use floating against each other, which must complicate transactions and, if it persists, hold back business development. Iraq also needs to figure out how to protect the savings of the middle class and people who want to join the middle class. It needs a viable banking system to make loans to help entrepreneurs and take deposits so people can aspire to increase their wealth. That requires banking supervision and regulation and a stable currency.

TIE: Thank you very much. ◆