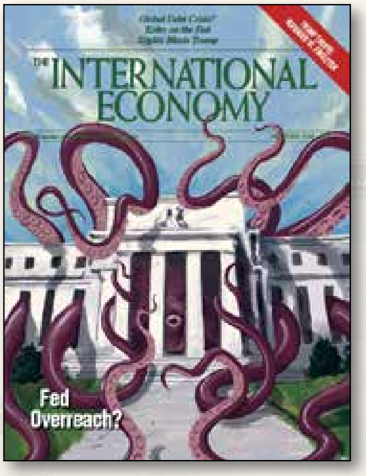
FROM THE EDITORS

THIS ELECTION SEASON saw a fierce battle over perceptions of the health of the U.S. economy. Despite falling inflation, a record-high stock market, and low unemployment, voters remained unhappy, as least partly over higher prices for housing and groceries. The U.S. Federal Reserve proved a useful target for candidates seeking to cast blame.



While the Biden-Harris administration over the past four years has maintained a position of respect for the Fed's traditional independence, former President Donald Trump during his 2024 campaign promised to lower interest rates, and said the president should have a greater say in Fed policy. Also, many of his advisers and possible administration appointees have criticized the Fed for playing politics, some pointing out the recent, historically unprecedented surprise 50-basis-point short-term rate cut coming less than a month before the presidential election. The robust cut was followed by unexpectedly strong employment data.

One Trump adviser has suggested Trump should appoint a "shadow" Fed chair, ready to step in when current chair Jerome Powell's term ends, as a means of signaling lower future interest rates to the market. Others have complained that after rescuing the economy following the 2008 crash, the Fed continued its quantitative easing and balance sheet expansion policies for far too long, pursuing too many objectives, distorting financial markets, and compromising the Fed's independence.

Some influencial Wall Street bond traders cite the Fed's poor forecasting performance despite the continuous input from hundreds of in-house Ph.D. economic experts. The bond traders suggest the Fed should reflect more humility and separate itself from the business of forward guidance, which increasingly "gets it wrong." Otherwise, the Fed as an institution will continue to lose credibility, they feel.

We will doubtless hear more as the new administration prepares to take office and begins to designate key personnel to manage its economic and financial policy portfolios. Ahead of any possible changes, former Fed Vice Chair Donald Kohn gave a brief interview to *TIE* editors defending the work of the Fed and the role it plays in markets and the economy.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
www.international-economy.com
editor@international-economy.com

A *TIE* Interview With a Fed Insider

Former Fed Vice Chairman Donald Kohn holds court.

TIE: **Some observers of the Federal Reserve are suggesting that the expansion of the Fed's role in the markets since the 2008 financial crisis has "disturbed the institution's unique independent role in the U.S. political system." Do you agree that the Fed politically is in a risky situation?**

Kohn: I agree that the political risks to the Fed's independence within the government could be rising, but it has little if anything to do with the size of its balance sheet. Pressures to keep rates low are likely to intensify as the federal debt rises relative to its income along with the costs of servicing that debt, especially if, as I suspect, interest rates will not return to the low levels of 2010–2019. Debt service will take an increasing proportion of the federal budget, threatening the tax cut and spending plans of both parties. The election of Donald Trump, who thinks he deserves a "say" in monetary policy, could crystallize those threats if a Republican Senate did not block Fed nominees who promised to do his bidding or the Supreme Court erodes the protections of governors, commissioners, and others who run independent agencies against their dismissal on policy grounds.

TIE: **Some analysts suggest the Fed's new standard monetary policy toolkit has become too complex to manage. The Fed's theoretical underpinnings are uncertain and the institution has a problem predicting economic consequences, according to one critic. Do you agree? At the end of 2010, the Fed predicted the economy would grow at a 4 percent annual rate in 2012 and 2013. Instead, growth came in at 2.3 percent for 2012 and 2.1 percent for 2013. Are the institution's models reliable?**

Kohn: The Fed's toolkit is more complex in that, in addition to the standard interest rate instrument, it includes securities purchases and extended forward guidance about those purchases and interest rates. That has been necessitated by the two recent episodes in which policy easing

Continued on page 54

Donald Kohn served as member and then vice chair of the Federal Reserve Board of Governors from 2002–2010. He currently is the Robert V. Roosa Chair in International Economics and senior fellow in the Economic Studies program at the Brookings Institution.

Continued from page 39

was constrained by the zero lower bound, so additional action was required to promote the Fed's dual legislated mandate for price stability and maximum employment.

That tool kit is not "too complex to manage," but it requires good forecasts and careful calibration. Forecasting has been challenged by the onset and recovery from the financial crisis of 2007–2009 and by covid; the projections of most economists and their models were off in both cases. Models—whether statistical or mental—are never entirely right and a characteristic of good policymaking and modeling is to recognize the errors and correct for them.

With respect to the toolkit, I believe both interest rate guidance and securities purchases could have been better managed in the post-covid period, and I have urged the Fed to use its Framework review of 2024–2025 to examine lessons learned from its use of these tools.

***TIE:* Some analysts worry that the Fed's habit of "riding to the rescue" has corrupted the "disciplining job" financial markets are supposed to do in the economy. A famous commentator called it "socialism for investors, capitalism for everybody else." Is this a fair critique?**

Kohn: No, it is not a fair critique. The Fed "rides to the rescue" of the economy as it is instructed to do in its legislation. Its interventions work through financial markets because those are the tools it has. If it didn't intervene and allowed financial markets to be disorderly or to tighten when the economy is already weak, it would be failing the American people by permitting high unemployment and deflation.

The Fed does not "pursue a wealth effect."

***TIE:* In her book, *Engine of Inequality: The Fed and the Future of Wealth in America* (2021), progressive financial policy expert Karen Petrou writes that the Fed's pursuit of a wealth effect to stimulate the economy instead produced "unprecedented inequality." Do you agree?**

Kohn: No, I do not agree. The Fed does not "pursue a wealth effect"—it has always been one channel through which policy ease stimulates spending, along with cost of capital, exchange rate, and credit channels. The Fed could

If the Fed didn't intervene and allowed financial markets to be disorderly or to tighten when the economy is already weak, it would be failing the American people by permitting high unemployment and deflation.

not turn off this channel without turning off the others by not easing policy, allowing the unemployment and deflation I referenced in my response to the previous question.

Prolonged periods of low interest rates help debtors more than creditors, offsetting at least some of the inequality that results from rising asset prices bolstering asset owners. Moreover, expansionary policy most likely reduces income inequality by expanding employment opportunities for all, allowing the least favored among us to take the first step on the ladder of wealth accumulation.

***TIE:* Some argue that the Fed's balance sheet is under water. It is running on a negative cash flow basis and has a negative equity position. Is it fair to say, as some critics do, that "the Fed's loss is Wall Street's gain"? But where does that leave the American taxpayer?**

Kohn: The Fed took interest rate risk onto its balance sheet by issuing short-term liabilities (bank reserves) in exchange for longer-term Federal debt. Taking duration out of the market was how it reduced term premiums on that debt, and with the resulting lower longer-term interest rates stimulated spending and employment. For some time, the Fed earned substantial profits on this balance sheet configuration, which it passed back to the U.S. Treasury Department and the taxpayers; recently as short term rates rose, that has turned to losses.

But profits and losses aren't the point—employment and price stability are the Fed's goals. This trade has helped to put people back to work; in effect it has created more taxpayers, to the benefit of all. ◆