The Kohn View

… on Powell, Trump, Covid-19, and Volcker.

Donald Kohn, *former Vice Chair of the Federal Reserve Board of Governors, and currently Robert V. Roosa Chair in International Economics and senior fellow in the Economic Studies program at the Brookings Institution.*

Every few years, *TIE* sits down with a veteran policy leader to gain perspective about the current period. What have they learned since leaving office? For this issue, *TIE* Founder and Editor David Smick and Executive Editor Owen Ullmann interviewed former Fed Vice Chair Donald Kohn.

Smick: Topic one is Federal Reserve Chair Jay Powell. How do you evaluate the Fed's response to this unique crisis? Where and when do you see them backing off?

Kohn: Powell and the Fed have done a fantastic job. By going all in quickly, and announcing programs even though the implementation has taken longer, the announcements themselves have had a calming influence on the financial markets.

Powell acted quickly on multiple fronts. He recognized that this is a public health emergency, and he didn't want the financial markets to make it even worse. I think his emphasis both through action and messaging on keeping credit flowing to U.S. households and businesses was exactly the right message. You want the markets and the banks helping households and businesses get through this difficult period in order to get back to full employment and minimize the scarring to the economy once the crisis is over.

Powell eased monetary policy as far as he could down to essentially zero, along with some forward guidance, and intervened in the Treasury and mortgage-backed securities markets when those were disturbed and not functioning. The problems in the Treasury market were the surprise to me. You'd expect people to be running to the safety of Treasuries in a crisis, but instead there were some highly leveraged players who had to unwind positions.

The Fed kept the credit flowing in the markets by lending to dealers through the discount window and also through the repo window. This helped get credit out there to businesses to assist them in retaining employees and holding their capital together so they could survive. I think that's been quite a comprehensive and effective response.

Smick: True, when this period is over, Jay Powell and his senior team will likely end up the heroes. We're fortunate Powell comes from a background of private equity instead of monetary theory. He didn't need theory here—he needed common sense. He didn't sit and have a debate, but instead threw a truckload of money at the crisis. There wasn't time for a theoretical debate about long-term inflationary expectations or how to somehow manage the yield curve. The Fed used to come in as the lender of last resort; this time, Powell made it the buyer of last resort.

I suspect Powell's personal calculation was that it was better to overdo it and then deal with the cleanup afterward. If he didn't do enough and the U.S. economy tanked, he would go down in the history books as a Hooveresque figure. I was impressed by the pragmatic approach of his entire leadership team.

Kohn: I agree, although I would say he built upon the structures put in place by a theorist, Ben Bernanke. The country was lucky to have Bernanke at the Fed during the Great Financial Crisis. Bernanke was an expert on the Great Depression. He knew that banking systems and credit markets were critical to getting the country going again and keeping unemployment from reaching 25 percent as we saw in 1930s. I think Bernanke did a fantastic job setting the stage. Powell then took what the Fed did under Bernanke and built on it further. Both of them deserve a huge amount of credit.

Smick: Do you worry about the independence of central banks in general? When I see the pressure being put on the European Central Bank by governments, I think maybe the Fed is the last of the relatively independent central banks. Even then, the Fed post-crisis won't be quite as independent as it once was. Or are my fears exaggerated?

Kohn: I've had concerns about the independence of the Fed for the last ten years. Republicans in Congress were attacking the Fed, saying it should follow a rule rather than use its judgement, and proposing to audit the Fed. These proposals came out of the last crisis. More recently, we've seen the attacks on Chairman Powell and the Fed by President Trump.

But Powell has handled Donald Trump perfectly. Powell ignores Trump. He never rises to Trump's bait, and keeps repeating the mantra, "These are the objectives Congress gave us, and we are doing our damnedest to hit those objectives. We are nonpartisan. We are using the best economic analysis available in order to do what Congress told us to do." Powell doesn't engage with the president in his rhetoric, he doesn't get defensive, and most importantly he reached out to Congress before this crisis to make sure members understood what the Fed was doing and the importance of the Fed's independence.

Powell and the Fed have done a fantastic job.

Smick: I'm told that Powell and his team's meetings on Capitol Hill in the months after he took office were very effective at distinguishing the Fed from the administration.

Kohn: Powell's not a theoretical economist—though he knows a heck of a lot of economics just from his time at the U.S. Treasury department and the Federal Reserve—so he can talk to members in language they understand. His reaching out to so many both in the House and the Senate, trying to explain what the Fed was doing, put him in a good position once the crisis hit. He had credibility that what he was doing was in the national interest because he had built this goodwill over time. That's been really an important achievement on his part.

I think the Fed can and will come through this with their monetary policy independence intact. There's a lot of cooperation with the Treasury department, but Powell has been very clear that the Fed's about lending, not about spending. To the extent there's credit risk being taken, the Treasury with support from the U.S. Congress is taking the risk by backing up these various facilities.

Powell's been careful to stay on the right side of several lines here, and that'll be very helpful to the Fed as we come out of this. I don't think that we'll have the same resentment about bailing out the banks and the financial markets as we had before.

Smick: If you look at the German court decision on the ECB's bond buying, there appears to be enormous pressure on the ECB to basically make up for Germany's slowness in using more of its surplus for stimulus. Are you worried about the whole European Union falling apart, given what we're seeing in Poland and Hungary right now with the central authority on the continent being questioned?

Kohn: I do worry about the tensions within the eurozone—the political stuff in the eastern part of the European Union, the economic problems in the south, particularly in Italy, and of course the German court decision. The eurozone's been a project in progress for some time. Without exchange rates to adjust and without a robust fiscal policy for the zone as a whole, it's been an open question whether enough fiscal stimulus will come from various individual countries, and whether countries that are having problems can adjust and recover.

However, I thought the tension in the eurozone was much higher back in 2011–2012. At that point, I wondered whether it would hold together. Clearly, the support for remaining in the eurozone even by the Greeks and the Italians is very strong. And though there are tensions, I'm optimistic the Europeans can find a way through.

Smick: Before the coronavirus, the developed world central banks were having a hard time hitting a simple 2 percent inflation target. Why was that? Are we undergoing a productivity revolution that's not being measured, thanks to advances cloud computing, artificial intelligence, and so forth?

Kohn: I didn't fully understand why it was so difficult to hit the 2 percent inflation target, especially in the United States when the economy was recovering from the financial crisis. We were close in 2018, then fell back again in 2019. Globalization may be a factor and productivity may not be being accurately measured, but economists have been digging into that very hard, and finding it very difficult to locate that unmeasured growth.

Inflation expectations were low after a weak recovery from the crisis. They haven't fully recovered, and they've been anchoring inflation on the low side of 2 percent until the more recent coronavirus crisis.

There's a heck of a lot of both fiscal and monetary stimulus going on now. People may be reluctant to return to work because the unemployment insurance benefits are currently substantial, and that will reduce labor force participation. I think that's time-limited, however, and people will be happy to come back to jobs that they think will be there.

To some extent, the supply side of the economy will be hurt. There's a lot of investment that hasn't taken place and that will hurt productivity growth. Meatpacking and auto factories are being reconfigured to operate in ways that they weren't designed for. A lot of businesses won't reopen. To be sure, they'll go through bankruptcy, debts will be restructured, and the capital will perhaps be left in place. But it's going be a slow process. Still, we've seen some productivity enhancements, such as advances in teleconferencing.

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Smick: Will a restructuring of the global supply chains contribute to lower growth rates?

Kohn: That will be a downside. Those global supply chains were extremely efficient. They were already being threatened by the tariff wars, and the effects of the pandemic response will just add to that. On the supply side of the economy, there will be some scarring.

Importantly, the demand side will be bleak. People will be reluctant not only to supply their labor at businesses, but also to purchase lots of products and services where there might be crowds—restaurant, travel, and so forth. Spending will be quite damped until there's a widely distributed vaccine and people feel safe.

Some changes in behavior could persist. Just as the savings rate rose coming out the global financial crisis, I think it will rise at least a little again. People will want to be ready for the next unexpected event.

For some time, the demand side weakness will outweigh the supply side decline, and the pressures on inflation will be quite muted. The effect will be more disinflationary than inflationary at least for a couple years.

Ullmann: If deflation were to last for perhaps two years, how could we get out of that trap?

Kohn: I don't think we will experience deflation as long as expectations are anchored. If I began to see some real drift down in those expectations, I might worry. But we started at close to 2 percent inflation—not at less than 1 percent. Once we get through this immediate oil price shock, I don't see deflation as a big threat. You obviously can't rule anything out, and getting back to that 2 percent inflation target will certainly be real challenge for the Federal Reserve.

Smick: Congress can't agree on much, but they seem now to agree that the Chinese are ruthless. Do you worry about the dollar's long-term status as the global reserve currency? The Chinese seem really determined to find some alternative to the U.S. dollar, and have been working on a digital yuan—the first digital sovereign currency. If they are successful in the long run, would that be a nightmare for the United States?

Kohn: In order to threaten to the global role of the dollar, a currency would need very liquid securities markets operated under the rule of law. You have that in the United States, in the United Kingdom, and to some extent in Europe with the euro, but it's not even close in China. China can complain all it wants, but I'd be very surprised if they came up with something that could replace the dollar.

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Still, there's unease due in part to weaponization of dollar payments by this administration, and also by previous ones. The dollar is being used as a tool in foreign policy.

I point to former Bank of England Governor Mark Carney's speech at Jackson Hole last summer where he suggested that a multi-currency "synthetic hegemonic currency" option in the Keynesian mold should replace the dollar.

Smick: We're seeing severe dollar shortages in developing economies, despite the Fed's efforts to establish dollar swap lines with central banks.

Kohn: There's been a huge outflow of investment from emerging market economies due to the sudden stop of economic activity and uncertainty about whether this virus can be stopped or will come back again. Even if those economies had been borrowing in another currency or in some international currency, the same thing would have happened.

The world is very lucky that the Fed recognizes the global character of dollar funding and the interest of the United States in having that market be orderly. Those nations that were holding dollar securities have an opportunity to turn them into cash. If anything, that will reinforce the dollar's role in the global economy. As it did in 2008 and 2009, the Fed is acting as lender of last resort for an array of countries, and for the businesses and banks in those countries going through their own central banks.

Smick: On this question of a stable currency in the Asian region, if someone is looking to park money right now, they're looking to the Japanese yen. Japan has a current account surplus, while China is running a current account deficit. The Japanese seem to value their new role as a regional anchor of stability—a role that China, given the murkiness of its financial system, can't hope to achieve.

Kohn: At the Fed's Jackson Hole conferences in the late 1980s and early 1990s, speakers talked about a tri-currency world with the deutschemark, the dollar, and the yen. Somehow, that hasn't happened. The dollar remains supreme. The yen remains, but doesn't have the securities markets and the infrastructure like the dollar has.

Smick: Plus, an economy with the global reserve currency has to be willing to put up with a strong currency at times. That's not very attractive for the Chinese export industry.

Continued on page 66

Continued from page 47

Kohn: French President Valéry Giscard d'Estaing used to call having the U.S. dollar as the reserve currency "the exorbitant privilege." Your point is well taken that demand for dollar assets increases the dollar's value and contributes to our deficit. Not everybody looks on that as a plus. But if people are willing to lend us money cheaply so we can buy their goods cheaply, that's a net plus over time. What we have ignored in this country is that the outsourcing of jobs, the strength of the dollar, the weakness in exports, and the strength in imports is having distributional effects. That gave rise to Donald Trump.

Ullmann: Suddenly Republicans have become very concerned about the ballooning budget deficit and public debt as a share of the economy. Do you see any longer-term threats from this unprecedented deficit and the additions to the national debt?

Kohn: Perhaps we will see problems over the longer term if we don't get the deficit under control. But right now, filling this hole of lost economic activity and income with fiscal policy is the right thing to do.

I have no problem with the current level of the deficit. Like many economists, I have worried that the trajectory of the U.S. debt—particularly given the demographics of the country—might be a concern over the long run. But as economist Olivier Blanchard pointed out even before this crisis, so long as the interest rate is lower than the growth rate, a country can borrow and borrow, using income from income taxes associated with the growth rate to pay the debt servicing. That doesn't mean the primary budget deficit—before debt servicing—can rise forever. Blanchard did say that at some point the markets will begin to worry about willingness to service the debt and repay it over time. But now is not the time to worry.

Ideally, the United States should go all in as we are doing, supporting businesses and households through this horrible period, and have a plan coming out for catching up to the debt. I don't see that plan right now.

China can complain all it wants, but I'd be very surprised if they came up with something that could replace the dollar.

For years, various committees and commissions have advocated for a sensible long-term trajectory for the U.S. debt, but the idea never seemed to get traction. Ironically, the huge Republican tax cut added a lot to the deficit. At the time, I didn't think cutting taxes when the economy was strong was a good idea. The tax cut seemed neither well-timed nor necessary. Reforming the corporate tax system was useful because the United States was a global outlier in that regard, giving businesses incentives to move offshore. But Congress attached a personal tax cut to the corporate restructuring. To deal with the deficit over time will involve slowing down the pace of spending, but also raising taxes and reversing some of those personal tax cuts from 2017.

Ullmann: You mentioned some structural changes you see resulting from this crisis. How do you see the state of the economy one year from now?

Kohn: I think we'll begin recovering in the second half of this year, and it could rebound quickly for a while as businesses re-open, but that will be limited. After that, it's going to be slower than people will be happy with. It's going to be a very long time before we get back to that beautiful place we were in a just a few months ago—3.5 percent unemployment, lower-income workers getting bigger raises, and more prime-age workers being sucked back into the labor force. We entered the coronavirus shutdown in a great position as an economy. It might take way more than two years to get back to that position. In the meantime, we'll need to adapt to a number of factors that will scar both the demand and supply sides of the economy. Resources will need to be reallocated to a post-pandemic economy with more working from home, different types of travel and entertainment, and restructured global supply chains, all of which will entail shifts in supporting physical and labor infrastructure.

Smick: From a global perspective, things look pretty scary—the growing balance sheets of the central banks, and the high level of public and private debt, like in the early 1990s when Japan had accumulated so much debt. Do you worry at night about the Japanization of the entire global economy? Will we enter a state like that of Japan—a decade or two of low-grade economic funk with constant disinflationary pressures?

Kohn: That is a concern. One reason, however, that Japan got into that position is because it was slow to act against the deflationary forces that emerged after its financial crisis in the late 1980s and early 1990s. The Bank of Japan took too long to get interest rates down to zero, *Japanification with its persistent zero interest rates is a worry and a reason to be aggressive in fighting both inflationary or disinflationary forces.*

and to aggressively try to keep inflation and inflation expectations up closer to the 1 or 2 percent target.

One thing we can be grateful for is that the Fed has been so aggressive in its commitment to trying to hit that 2 percent inflation target. Even so, people ask why we can't be happy with, say, 1.7 inflation. My concern is that after we say 1.7 is okay, next it will be 1.5 percent, then 1.4 percent, then the economy is on its way down the Japanification rabbit hole.

Having inflation expectations maintained around 2 percent is really what keeps nominal interest rates from sinking to zero when the economy isn't under stress. Japanification with its persistent zero interest rates is a worry and a reason to be aggressive in fighting both inflationary or disinflationary forces.

We need to be careful not to paint too adverse a picture of Japan. Japan maintains a very high government debt-to-income ratio—240 percent or more. There's nothing automatic that once an economy gets to a high debt-to-income level, then markets will be afraid and interest rates will rise, crowding out private investment. Also, Bank of Japan Governor Masaaki Shirakawa used to point out that on a per capita basis, GDP in Japan hasn't done that much worse than the United States.

Still, right now, Japan is in a very dangerous position. What do you do when you have negative interest rates, and then you're hit with a bad shock? At least the Fed had a little room to reduce rates. That was a nice demonstration about why it's good to have some room to operate monetary policy.

Smick: Here's a more positive question for the United States. Tell me if I'm wrong. Since the financial crisis, despite a global recovery, the world has still experienced deindustrialization and a decline in trade. The U.S. economy is less dependent than most on trade exports as part of its GDP. China's export share of GDP is down, but they're still at 20 percent. South Korea's share is 40 percent, Germany's is 39 percent, and Japan's is 16 percent. Most of our competitors are dependent on trade. For China, manufacturing is still about one-third of their GDP.

So you can make a case that, even before the coronavirus hit, the United States with its flexible service economy and high-tech sector was best positioned to make its way in this new environment. Even with the coronavirus meltdown, are we still in that position? Corporate leaders in every boardroom worldwide are asking whether the benefit of having a supply chain stretched around the globe is worth the risk, putting China at a disadvantage. This issue of divergent values seems to be rising to the top of the list of concerns. Does this view of the global landscape make sense?

Kohn: Because the United States is largely a service economy, we may be better positioned to deal with the slowdown in globalization and the breakup of supply chains. But the whole world is worse off. The ability of trade to raise billions of people out of poverty around the world—which it has done in Asia and was poised to do in Africa—is a wonderful thing. It's also wonderful, on balance, for the United States. Those cheap jeans and sneakers from Walmart that help raise the standard of living for people down the income scale were made in Vietnam, China, and Indonesia. We benefitted from globalization and more efficient resource allocation around the globe that lifted many people out of poverty.

However, in the United States, we didn't pay sufficient attention to the fact that although as a country we were better off, certain sectors got slammed pretty hard and those people needed help to transition to different jobs that were going to be in demand in the twenty-first–century economy.

There's a lot of evidence to show that openness around the world helps productivity around the world. Ideas flow. Businesses in open economies are pressured to increase productivity. Now, instead of opening, the world is closing, as begun by the global financial crisis and accentuated by the Trump weaponization of tariffs. Following the Covid-19 pandemic, supply chains will be drawn back even more.

I fear that we're hurting the long-term prospects for rising standards of living in the United States and around the world. In the United States, our growth potential is being hurt by cutting off immigration. Why were U.S. demographics much less tilted toward older people and much less worrisome than other counties? Because we were open to immigration. People were coming in and paying taxes and taking jobs. Shutting off illegal immigration is absolutely necessary, but the worrisome trend now seems to be slamming the doors on legal immigration as well.

Smick: It never made sense to me why we educate the young geniuses of the world in our top graduate schools, then send them home. What's wrong with stapling a green card to their diplomas?

Kohn: We have become much less welcoming to people from India, China, Eastern Europe, Africa, and South America who come here for education. Many would like to stay. I heard Alan Greenspan say many times we should issue green cards along with diplomas.

Smick: I've always felt that we didn't pay close enough attention to the downside of globalization—saving shifts that have led to the underpricing of financial risk. Indeed, every ten years or so we have the psychological scarring of another financial crisis. How do we break this cycle?

Kohn: I agree with you to some extent but not entirely, and the potential for the adverse effects of globalized financial markets isn't new. In the 1970s, the recycling of petro dollars into the U.S. banks gave them an incentive to lend those dollars out to other countries in ways that weren't safe. Walter Wriston, the former chairman of Citibank, was appropriately ridiculed for saying countries couldn't default. A few decades later, we had excessive risk-taking in the U.S. subprime housing market, some of it financed by banks in Europe. Even the people in charge weren't seeing the risks that were there. Where I differ from you is you implied in your question that the current financial crisis resulted from another round of over-borrowing.

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Smick: No, this was a mandated shutdown.

Kohn: But your point about risk taking is well made in that to some extent, the damage to the financial system from this health-caused crisis is working through overleveraged businesses. The Federal Reserve, the Financial Stability Oversight Council, and others have been worried about the overleveraging of businesses.

These weren't zombie corporations that were being kept alive when they should have failed. Rather, good corporations were taking on more debt than could be handled if something bad happened to them. Similar to the leadup to the subprime crisis, we saw leveraged loans, junk bonds, the repackaging of leveraged loans and CLOs, and the covenants on those loans being loosened. Leveraged lending didn't lead to this crisis; it was a health-caused crisis. But many corporations in the United States, Europe, the United Kingdom, and other places are too highly leveraged to withstand a shock. Central banks and governments are reluctant to bail them out. Overleveraging in the business and corporate sectors has probably made the shock to the real economy a bit bigger than it otherwise would be. We need to think hard about what tools the authorities should have to control the stability risks from this kind of build-up in leverage.

Smick: Are we about to see a major new era of corporate and sovereign debt forgiveness or restructuring? This period reminds me of the late 1980s and early 1990s, when the developing world saw the emergence of Brady Bonds.

Kohn: Maybe businesses would have been able to deal with the debt if things had continued along the nice smooth path of economic growth that we seemed to be on. But that growth wasn't resilient to a negative shock. There's going to have to be some restructuring.

The United States is going to have a whole bunch of corporations, partnerships, and sole proprietorships in trouble over accumulated debt. They're going to emerge from this crisis with higher levels of debt, and maybe, after several years, the same level of income. Many aren't going to emerge. We're in for a major restructuring of debt here in the United States if this crisis carries on much longer. If we rebound rapidly in the second half of the year and get back to where we would have been anyhow, that could be minimized, but I don't think that's a reasonable prospect.

Ullmann: During the Great Depression, the role of government expanded dramatically and permanently. Do

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
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Paul Volcker taught me about when to go full in, and when to back away.

you think, in the wake of this crisis, we will see a similar government expansion?

Kohn: I think there will be some expansion. It's clear that our health care system is not prepared for something like this pandemic. We need to have a health system that's up to the standards that we should expect and can rise to the occasion.

People are losing their health insurance coverage because they're being laid off in the middle of a pandemic. There needs to be a reaction to that. I'm not in favor of single-payer or Medicare for All, but the system itself and the people's financial and physical access to it need to improve. Some have talked about this leading to more support for a minimal level of income. I think there would be a lot of resistance to that idea.

But there will be more respect for the role government can play, particularly in an emergency, and the importance of having a competent government with knowledgeable people. I hope there's less fear of the so-called Deep State. It's the Deep State sitting over there at the Federal Reserve designing these facilities to keep the financial markets and the banking system running. It's the Deep State down there at the Centers for Disease Control and Prevention and the National Institutes of Health helping us get through. We need the contingency plans, the coordination, the non-partisan expertise, and the kind of deep knowledge you find at the NIH and the Federal Reserve and the Pentagon and many other areas of the government. I hope that people will recognize that shrinking the government and disrespecting the people who work for it are not in the long-run interest of the United States.

Smick: When you look back on your career, what was the biggest surprise?

Kohn: The biggest surprise to me was the 2008–2009 financial crisis. Before that, looking back on my forty years at the Federal Reserve, a big surprise occurred on October 6, 1979, when then-Chairman Paul Volcker assumed that he had to change techniques in order to fight inflation. That changed everything we did in terms of implementing monetary policy. I was not at that FOMC meeting—I was a couple layers down on the staff—but certainly was involved in implementing Volcker's policies.

In the aftermath, there was high unemployment. Farmers on tractors protested around the Fed building, consumer groups picketed us, and Volcker agreed to send senior staff and governors out to community meetings. I was sent out to meet a group in Seattle with Janet Hart, who was head of our consumer affairs division. This group was organized along the principles of Saul Alinsky, the activist in Chicago. We met at a Catholic high school on a Saturday morning. The organizers kept us in a classroom while they whipped the crowd into a frenzy.

We learned some lessons from Volcker: Decide on an objective, do what's necessary to hit that objective, and know through both experience and analysis that hitting that objective will further the welfare of the American people over the long term.

Smick: Volcker was tough. Very few people could have withstood as much political pressure as Volcker did when he broke inflationary expectations with such a painful policy. He knew it had to be done. The status quo was unsustainable on all accounts.

Kohn: Another lesson I learned from Volcker was when to back off. During the 1982 Mexican debt crisis, U.S. commercial banks were threatened because of their exposures in Mexico and Latin America. Inflation was down, but not as low as he wanted it. We were in a deep recession, and Volcker started to back off on money supply targeting in August–October of 1982.

I heard Alan Greenspan say many times we should issue green cards along with diplomas.

Paul Volcker was certainly my hero and a mentor to me. He taught me about when to go full in, and when to back away. When you've won most of the battle, you can win more of it later, now you've got to save the system.

TIE: Thank you very much. ◆