THIRD WAY

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Inside the Federal Reserve

Third Way

Introduction:
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Featured Speaker:
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JIM KESSLER: All right. We're going to get started.

Thank you for coming out. Let me just mention before I introduce our guest that our next two capital markets lecture series will be – the first one's going to be September 19th, and it's going to be Martin Feldstein will be coming. That should be really interesting. And then October 8th it's going to be Senator Chris Dodd. So those are the next two coming up. And of course, we'll send out invitations.

By the time the average person turns 40, they've held jobs with about 12 different employers. Our guest today, Donald Kohn, had the same employer for 40 years, the Federal Reserve. He's had an extraordinary career and is one of the most influential members of the Fed in history. He's a rare individual who went from being a line employee at the Fed to becoming a presidential appointee when he was tapped by

President George W. Bush in 2002 to be a Fed governor. In 2006 he was named vice chairman of the Fed. He has been called, quote, the most important non-chairman member of the board in the history of the Federal Reserve. Fed Chairman Alan Greenspan called Donald Kohn a mentor. He was Ben Bernanke's right hand man during the financial crisis as the Fed sought to rescue the economy in the midst of crisis on the fly. At the dawn of the financial crisis, he warned other central bankers in Europe, quote, we have to be prepared to think the unthinkable. And he's one of the unsung heroes who took extraordinary measures to rescue the economy at the bleakest moment since the Great Depression.

We're honored to have Donald Kohn with us today. He's going to speak for a certain period of time. He's eager to take your questions. He's a native Philadelphian, as am I, a graduate of the college of Worcester, where he remains an active alum, earned his Ph.D. from the University of Michigan, currently a senior fellow at Brookings and someone who used to ride his bike to work. Donald Kohn, thank you so much. (Applause.)

DONALD KOHN: Thank you. Thank you, Jim and John (sp). Thank you, guys, for turning out on a beautiful Friday afternoon when I'd rather be somewhere else. (Chuckles.) So I appreciate your being here.

So I've been asked to talk about monetary policy and the Federal Reserve. And I'll try to talk for approximately half an hour and then open the floor for questions and give some general background here and talk about the current situation or the recent situation.

So the goals for monetary policy are set in the Federal Reserve Act. They're legislatively established. I think this occurred in 1978, when these goals were put in. Maximum employment, stable prices and moderate long-term interest rates are the three goals that are in the act. People usually don't pay any attention to the moderate long-term interest rate goal because that's thought too – thought to flow naturally from keeping inflation low, so stable prices should

produce moderate long-term interest rates. Therefore, the Fed's objectives have been characterized as a dual mandate: maximum employment and stable prices, usually what's emphasized there. I think there are a number of issues around this – around this – these objectives. And let me cover two of them that have come to the fore of late.

One is the objectives give equal weight to maximum employment and stable prices, or the so-called dual mandate. Most central banks these days have hierarchical mandates. They're inflation-targeting central banks, so they're given – let's say, the Bank of England is a good example; the chancellor gives the Bank of England an inflation target to present, which seems to be the goal that most central banks have for measured consumer inflation. And then it – and then the remit from the chancellor says, subject to achieving that target, you should pursue goals of employment and growth – so first, inflation, then employment and growth. And that's common. The ECD just has an inflation target with no even secondary objective for employment and growth. The reason the inflation targeting has turned out that way is because of economics and thinking about what a central bank can control.

The unemployment, the employment situation is subject to influence by the central bank over the short run. You can – if you raise interest rates very high, you can create unemployment. If you lower them a lot and do some other things, which we'll talk about in a second if – once they get to zero, you can increase unemployment. But over the longer run, over years, decades, the level of unemployment that the economy can support is given by the structure of the labor markets, it's demographics, the productivity, et cetera, et cetera.

Inflation is different. So Milton Friedman said inflation is everywhere and anywhere a monetary phenomenon. The central bank can control the rate of inflation over long periods of time. So the central bank can set and achieve an inflation target. On its unemployment target, it needs to be

very aware that it's not in full control. The structure of the economy, the structure of labor markets are really important. So it needs to recognize that it can say we think that full employment is 5 ½ percent today or 5 ¼ percent but then be prepared to adjust that estimate as information comes in about how the structure of labor markets might be affecting it.

I would say for the most part, it doesn't – whether you have a hierarchical inflation first and subject to that unemployment or this dual mandate doesn't really matter very much as long as the central bank understands that they can't push the unemployment rate below its long-run sustainable level of long periods of time. And they shouldn't because they also have the price stability – price stability mandate. The Federal Reserve recognize – so there is no long-term trade-off. You can't have a little more inflation and a little less unemployment over the longer run. If you try to have a little more inflation, people become – come to expect inflation will be higher in the long run, and it kind of gets built in. So it's not – there is no stable trade-off between a little more inflation, a little less unemployment. You can't really push that unemployment rate away from its long-run sustainable level and have stable inflation, low stable price stability inflation at the same time.

The central banks, the Fed recognizes this, the difference between those two targets. And in fact, in January of 2012 it put out an explanation of its objectives. And it said we're seeking 2 percent inflation. We're also seeking full employment subject to the congressional mandate that was have in the Federal Reserve Act. But we recognize that the measurement of full employment depends on all these other things, and we need to revise our estimates as we go on. And there hasn't been any conflict, right? So we've just been through a seven-year period or six- to seven-year period in which inflation has been below the 2 percent target and employment has been below any measure of full employment. And so by both measures, by both objectives, the Fed's been all-in, let's try and stimulate the economy, and it's been –

they wouldn't have done anything different if they've had just inflation target. So the Bank of England, for example, has been just as innovative and stimulative in its policies as the Federal Reserve has been, even though it's had an inflation target – in fact, they did a lot of that with inflation above target, but they felt that it was above target for temporary reasons so they could project it coming down. So I think having a different set of targets or a different – a hierarchy of targets really wouldn't have affected policy over the last while. But there is – this comes up, even in congressional proposals, from time to time to change the – change the thing to make it more an inflation target.

The second difficult issue these days in particular is the role of financial stability in making monetary policy. So the monetary stance can affect risk-taking in financial markets. Think about the current situation: Interest rates are essentially zero or short-term rates are essentially zero. If you want to end – the Fed has put downward pressure on intermediate and longer-term rates, and I'll come back to how they've done that in a second. So people worry about investors in the search for yield. People who are investors who are not satisfied with the rates they're getting in the market can go get higher rates by going out the risk curve. And the question is whether they recognize the risk they're taking and whether they're becoming vulnerable to a – the eventual increased interest rates while they're doing that.

Some people assert that the low interest rates of 2003, 2004, 2005 – in 2004 and 2005, the Fed was raising rates. We got to 5 ¼ percent in early 2006. But some people assert that those very low rates led or at least contributed to the bubble in housing prices and the financial risk-taking that was going on at that time. My personal view is that the contribution of Fed monetary policy to those problems was very small, marginal at best, if any, and this was mostly about the financial sector taking risk, mostly about terms and conditions of lending getting very, very easy, mostly about the private sector not understanding the risk it was taking and the regulators not exerting sufficient restraint on the

private sector when it was taking the risk. So my – from my perspective, the mistakes that were made leading up to the crisis were much more in the supervision and regulation side than they were in the monetary policy side. But that is a – there are people who would argue with me on that.

So the question arises after the crisis – and this has been hotly debated in conferences all over the world these days – should monetary policy pay more attention to financial stability issues? So if you think that – in making policy. So if you think that these really low rates are leading to a buildup in risk in the financial systems, as folks take risk that they're not accustomed and they don't understand, why shouldn't we sort of raise rates, shouldn't the Fed or central banks more generally raise rates a little to lean against this kind of thing?

I think there are – there are a number of – a number of issues here. One is it's always hard to stop – to spot, excuse me – excessive risk-taking. It's hard to raise interest rates in a timely way, to stop it in time to prevent the crash. And then it's not clear how effective a small increase in interest rates would be in doing something about the building of vulnerabilities. It might take a very major adjustment in interest rates to damp down the risk-taking in the economy. And that – and that brings forward I think the real issue here is that if you're going to use monetary policy to, let's say, tighten, even though inflation is running low and unemployment's running high, you're going to get lower inflation and higher unemployment. So there is a trade-off using monetary policy to address financial risks in instead of looking at the objectives that Congress gave for maximum employment and stable prices. And I think there are – it's not clear to me that the people who advocate using monetary policy for this recognize those trade-offs as much as they should.

Sweden is a nice example, by the way, of a country in which policy has been run tighter, that Sweden is an inflation target in country, but they're run a somewhat tighter policy than is

consistent with their inflation target because they are worried about the buildup of household debt, so they're trying to make it more expensive for households to borrow. The result has been it's had very little effect on household borrowing, and Sweden is facing deflation and higher unemployment than it otherwise would and recently backed off that policy, lowered their interest rates at 25 basis points. So I think it's very hard to use monetary policy for these financial stability purposes, and it has a cost.

As a consequence, or one the things that's come out of the crisis is a policy called macroprudential policy. So this is – think about a missing tool. So you've got a problem. You need your monetary policy to hit maximum employment and stable prices at the same time you see problems developing in the financial industry. Why can't we use supervisory and regulatory tools to address those problems in the financial industry rather than monetary policy? So these so-called macroprudential policies is missing tools to address stability. It's using the microprudential, it's using the supervision and regulation of banks and other parts of the financial market but adding a little extra to that when you see the system getting unsafe. This certainly is the position of Ben Bernanke and Janet Yellen has been we don't want to steer away from putting people back to work and getting inflation to 2 percent. We prefer to use these other tools that to some extent were created in Dodd-Frank and by Basel agreements to address the financial stability issues, and the Fed is trying to do that – is trying to do that now.

My personal view is the U.S. system isn't very well structured for a good use of macroprudential tools because we have so many regulatory agencies. The Financial Stability Oversight Council was created in Dodd-Frank to think about the systemic risks in the system and address those systemic risks. It's a pretty clunky structure. It's got all those agencies on there. The agencies themselves don't necessarily have financial stability objectives. And you've seen pushback from, say, the SEC to the recommendations of the Financial Stability Oversight Council with some SEC commissioners

saying, who are those guys to give us – make recommendations to us? We have our law. We're going to uphold our law. They don't know what they're doing. So it's really hard to put the macroprudential loss on this. But it is I think a productive way to think about how to accomplish multiple goals with multiple tools. So use your monetary policy tools for maximum employment, stable prices. Use your supervisory regulatory tools for financial stability. And only if they don't work, then use monetary policy for financial stability.

So how do – how does the Federal Reserve achieve these goals of maximum employment and stable prices? I'm going to run briefly through what happens in normal times and then show how that had to change in the middle of the crisis and what the Fed did.

So in normal times, if you had a situation like we've had for the last couple years in which unemployment was running high and inflation was running low relative to the your goals, and the Federal Market Committee, which is the Fed Reserve group that makes these decisions, met, we'd have been sitting around talking about how to lower interest rates because when you lower interest rates and the Federal Reserve operates at the very short end, usually, normal times operates at the very short end of the interest rate market, had a target for overnight interest rates – so if we'd come on while I was on the board in the FOMC in 2002, 2010, or at least 2002 to 2007, when the crisis hit, and we had been in a situation of weak employment and weak inflation, we would've said, let's lower the federal funds rate.

If we lower short-term interest rates, what tends to happen is intermediate and longer-term rates tend to go down, so no one borrows, except banks from each other in the overnight market, right?

When you and I want to buy a house, we're taking out a 30-year loan or maybe even it's a flexible rate loan, but that's a one-year interest rate. If we want to buy a car – if we want to borrow to buy a car, it's a three or four year loan. A business

wants to put up a building, that might be a 10, 15, 20 year bond. Or even if they want to buy equipment, that's probably a loan that lasts a few months. So the overnight rate by itself is not important. It's the movements in that overnight rate and what they do to other interest rates and other asset prices that are important.

So we would have come into that meeting and said: Low inflation, high unemployment, let's lower the overnight rate. That would have put downward pressure on intermediate and longer-term rates. So mortgages would have been more affordable, cars would have been more affordable, et cetera – inducing people to spend for more cars and more houses, inducing businesses to spend on capital equipment.

The other thing that happens when intermediate and longer-term interest rates go down is stock prices tend to go up. Think about making a decision about whether to invest in the stock market or invest in the bond market, the yield on bonds go down, stocks look a little more attractive, don't they? If you want to discount the expected future stream of earnings you do it at a lower interest rate.

So when interest rates go down, stock prices tend to go up. When stock prices tend to go up, anyone holding that equity – whether it's in your 401(K) or what you own yourself or what you own, you know, separately, you're going to be wealthier than you otherwise would be. So as your wealth goes up, you say, well, gee, I got a little more net worth than I had last year. I can afford to spend a little more than I was thinking I would spend.

So there is a wealth effect from monetary policy. The rule of thumb used to be – I think it still is – a dollar of additional wealth in my balance sheet, my portfolio, induced about 4 cents of spending. It's not a lot but it's a little, right? So lower interest rates help wealth, they lower the cost of capital and borrowing, they increase people's wealth.

The third thing that happens is they tend to put downward pressure on exchange rates. So you have a choice – invest in

Europe, invest in the U.S. Interest rates are lower in the U.S. You'll more likely turn to Europe for buying bonds rather than the U.S. That puts downward pressure on the dollar. When the dollar goes down our exports are cheaper to people overseas and imports from overseas are more expensive here. And that helps spending.

So there are these channels that work when the Federal Reserve, with lower short-term rates, working through all these channels. So think about November, December 2008. The economy is in free fall. Inflation is dropping like crazy, well below 2 percent. It's the deepest recession since World War II – since the Depression. We didn't know at the time how deep it was, but we knew it was very, very bad. And the interest rates were already at zero.

So this was, what do we do now kind of moment, right? So we said, OK, we can't lower the short-term rate, but maybe we can do something about those intermediate and longer-term rates, lower those, and then work through all these channels – the wealth of cost, the capital wealth exchange rate channel. Let's work on those directly. So we instituted a program to buy securities, to buy, in this case, mortgage-backed securities and then, in the spring of '09, Treasury securities, buying intermediate and longer-term securities.

Any time you buy something, that tends to drive up the price, right? The price of bonds goes up, the interest rate – the interest rate goes down. It also helped the – buying the mortgage-backed securities – that market, in the fall of '08 was pretty frozen up, even though it was an agency market. And that helped to free that market up and helped to get funds flowing into the mortgage market again. So buying securities directly worked on the intermediate and long-term rates, directly drove them down and then activated those channels we talked about.

It also sent a signal, gee, the Fed really is worried. They're worried enough to do something they've never done before – buy these longer-term securities. So we can be pretty – we, the market, can be pretty confident these short-term rates

are going to stay zero for a very long time. So there was a signaling effect of the purchases. Over time, the signaling part of this – you can count on short-term rates remaining low for a long time so that'll help hold down intermediate and long-term rates, became more and more important in Fed policy.

When we first started this in the fall of '08, spring of '09, we had very vague terms, like rates would remain – policy would remain at this extremely accommodative level for some time or an extended period, something like that. And then later, when the Fed was still doing the asset purchases but was sort of shifting their attention to the expectations to trying to – trying to make sure people knew they were going to hold interest rates at zero for a while, they put more attention on the so-called forward guidance – on the – on the signaling about what they intended to do with interest rates.

So at some point in 2012, I guess, they said they were going to keep rates at zero at least until the unemployment rate was below 6 ½ percent. So all tying those very low short-term rates to economic conditions. The unemployment rate, as you know, has fallen below 6 ½ percent, so now the guidance is more vague. They're saying they're assessing progress towards the dual mandate using a variety of indicators of labor markets and inflation. So the guidance part has become more important and the Fed is in the process of phasing out their QE – their purchases of securities.

Natural question is, did all this work – these unusual, unconventional – UMP, unconventional monetary policies? I think they did. So when you – people have done a lot of studies about the effect on financial markets of Fed announcements of these policies. And they pretty much universally – uniformly show that when the Fed announced and unconventional policy interest rates went down. Didn't always happen, didn't happen by a lot sometimes.

They also tend to show that equity prices went up when these policies were announced. I'm not sure what they show about the dollar, actually, how that I think about it. But I think in

general, the purchases of securities and the guidance about rates staying low for a long time have had their intended effect on interest rates and stock prices and probably on the dollar as well. Has those lower interest rates, higher stock prices, lower dollar affected spending the way they were designed to? That's a much harder question. And it's hard to answer.

I think they must have. If I ask myself the counterfactual – so part of – I think one of the problems the Fed has had here in defending its actions is its defense against the counter – if we hadn't have done this, what would have happened? So you're sitting in the middle – think of yourself from the Fed's perspective. You've done a lot of unconventional things. The economy's growing, but not as fast as you want it. Inflation is lower than you wanted it. And people are saying, oh, it didn't work.

Your defense really is, well, if I hadn't done these things, things would be even worse. That's a hard thing to sell to people. I think it's true. I ask myself, suppose interest rates were higher now or had been higher over the last couple years. Suppose the Fed hadn't have bought those securities? Long term rates would have been higher. Would the economy be in better shape now? And I – the answer to me is clearly – is clearly no, I don't – I don't think so.

So higher interest rates would have been lower stock prices. It would have been higher exchange rates. It would have been costlier mortgages, auto loans, et cetera. That can't be good for spending. So it's very hard to prove these things were effective in stimulating the economy. But I think logic suggests that they were and things would have been worse.

What are some of the challenges that the Fed's facing? So I've got about five minutes to talk here. Let me go over a few of these challenges now and then we can open it for questions. So they're, as I said, in the process of phasing out their purchases. They've said that unless things are very different than they anticipate, they'll have stopped buying securities in October. October will be the end of their QE

program. But they still have in place this guidance about rates staying low for long.

What are the issues they're facing? Well, one issue is the financial stability issue. We've already discussed that. Are – is – are there policies leading to imbalances and problems in the financial markets that will come back to bite them when rates eventually do increase? And no one can be sure. No one knows what's going to happen when eventually rates start to increase, but they are doing a bunch of things trying to make sure the system is resilient to the eventual increase in rates. Among these are the stress tests on banks, which say to the banks what's going to happen to you when interest rates rise and rise by a substantial amount. Let's test your portfolios, test what losses you have, test whether you have enough capital to withstand this.

They've also given out – one – among the areas that people are most concerned about is leveraged loans, loans to businesses that are already highly levered, and the Federal Reserve has leaned all over the banks to be very, very careful about this, to not back off on the kinds of covenants and restrictions that these loans usually have, with mixed success, I would say, so far. But it's been a very – so using the supervisory process to try and control some of this risk-taking so that when rates rise, things don't – things don't come apart.

A second issue they're dealing with or have had to deal with are the global effects of policy. So emerging market economies, India, Brazil and others complain mightily both when the Fed did its QE and then when the Fed started to unwind its QE. So they didn't like either side of that. When the Fed did the QE, they said that by having really low interest rates in the U.S., it was – capital was rushing into the emerging market economies, raising their exchange rates, et cetera. And then when they started to unwind the QE, the complaint was, well, capital is rushing out and that's giving us problems by itself.

I think the Fed's – the Fed's response is, Congress has given us objectives for the United States. They have said you must

promote price stability and maximum employment in the United States, not in India or Brazil. They are responsible to and accountable to the U.S. Congress, which is in turn responsible to the people that elect them. So it's just inconsistent with law for the Fed to say to the U.S. folks, you – more of you will need to be unemployed, so Brazil and India don't run into problems. That's not going to work.

But I think the second point is that, in truth, Brazil and India – and I'm just using those as two big countries that have complained; there have been others – are better off, the global economy is better off with a good, solid, stable U.S. economy. We are the most important economy in the world, even if others are gaining on us in size. Nothing is as important as the U.S. economy and financial markets to global – to global economics. And having the U.S. growing, having stable, low, stable inflation in the U.S. is in everyone's – in everyone's interest.

I think the other point that's made is, those emerging market economies that's had problems either with the inflows of capital or the subsequent outflows are usually economies that had generated those problems on their own. They had issues themselves that they hadn't addressed, and when the capital started flowing back out again, all of a sudden those issues were very, very clear. So they need to address their own problems.

The third issue – so financial stability, global effects, inflation. I can recall in the spring of '09, April-May of '09, after we started our QE program going to all kinds of conferences – academic conferences from Stanford, Hoover to Asheville, Vanderbilt; Princeton, New Jersey, and economists standing up there and putting up a slide which showed the Fed's balance sheet actually projected and saying we have never seen anything like this before in – that hasn't resulted in hyperinflation. So how often that I hear Weimar, Zimbabwe. You, Don, and your colleagues are leading us into this thing.

Well, it didn't happen, right? So inflation's lower now than it was a couple years ago. It's rising, but it's still below the Fed's target. So I think the inflation fears – and the reason

inflation's low is because there are unemployed resources. There are people willing to work at relatively low wages, who are looking for jobs. There are businesses who don't need to raise prices because the cost of labor is pretty low, and don't see the pressure to do that. So that tie between the size of the Fed's balance sheet and the rate of inflation just didn't happen, isn't happening, OK?

So I think so far inflation has been below the goal. The dollar has risen over the last few years despite warnings that the Fed was debasing the currency. It's just the economic situation has not resulted in inflation despite the size of the Fed's balance sheet. So I don't think inflation's a problem, provided – and this is my fourth point – that the Fed exits in time. So it's got the hard thing they're doing right now is trying to figure out when to wind down these programs, when to begin raising interest rates. It's not – there aren't any easy answers. In my view, there aren't any formulas, despite some proposals that formulas be followed. This is – these are unprecedented situations. The Federal Reserve, thanks to the U.S. Congress, has the tools to do what it needs to do.

So in September '08, the Congress gave us the ability to pay interest on the deposit balances, the bank's reserves at the Federal Reserve. When I testified in favor of the Fed having that power, I thought that interest rate would provide a floor for short-term interest rates. It hasn't quite done that. It's been a soggy, kind of leaky floor. But there's no question in my mind that when the Fed gets ready to raise interest rates, they'll be able to raise interest rates. And they've developed new techniques since the fall of '08 to reinforce the rise of interest rates. It will be complicated, technical and all that stuff. But when they're ready to exit, they can exit. So the technicality of exiting, even with this huge balance sheet, is not really an issue.

The policy decision will be very hard. You don't want to do it too early, because if you do it too early you could send the economy back into recession, and we've already got a weak economy. You don't want to go too late, because then inflation might get going.

Now, in fact, we know what to do about inflation. You can raise interest rates. And there's no limit on the interest rates you can raise. So I think if you were – if I were a Fed policymaker, I'd say, I don't want to make any mistakes, but the – if I had to make a mistake, I'd rather make the too-late mistake. I know how to cure that. I know how to come back from making that mistake. The too-early mistake, raising rates too early, sending the economy back into a weak – into a recession or a very weak growth, it's hard to cure. We've seen that over the past few years when interest rates are already low.

And the final point – and you can get this from some of the thing – from a little bit of my incoherence here is how to communicate about the exit. So this is – clear communications is something everybody wants the Fed to be doing. The Fed wants to be communicating clearly. This was one of the major objectives that Ben Bernanke had when he came into office in 2006 was to improve Fed communications and transparency, and he's done that. It is very important because markets are extremely sensitive to what the Fed is saying and how the Fed says it and what it says affects people's expectations about interest rates, and that affects the economy, so getting it right is really important.

But it is really hard. This is an unprecedented economic situation. It's an – at least since the Great Depression, it's an unprecedented policy situation. We are on uncharted waters. It's hard to use – impossible, really, to use guidance from the past about what would you do in this situation because we've never been in this situation before. I think the crisis and the resulting very slow recovery showed that we as economists had some very large gaps in our understand of how the economy worked and how the financial markets related to the economy that we're just trying to fill in – just trying to fill in now. There are a lot of levers to push and pull in this exit, so it's a very hard thing to talk about, clearly. And there are a lot of divergent views within the Federal Reserve and when and how to exit, and that's good. I mean, the reason Congress created a committee to make monetary policy rather than appointing a czar or a czarina to make monetary

policy is because they wanted divergent views being brought to bear on some very complex and difficult issues.
But the divergent views, with lots of people speaking out, make it very hard to communicate – for the Fed to communicate clearly when there are lots of different people on the committee speaking out about – in different ways, saying what they think the committee should be doing, should do.

So clear communication is essential and very, very difficult. Let me stop there and see what questions you guys have.

MR. KESSLER: Questions from anybody?

MR. KOHN: Wow.

MR. KESSLER: Let me – let me ask the first question, just – (inaudible) – questions.

MR. KOHN: OK. Sure.

MR. KESSLER: I have a few that I've written down. So let me – let me ask this one. I've heard this from somebody who's involved in the financial markets. I always ask, what do you see that you're concerned about? And this person said to me – and I'm quoting – he said there is an epic amount of corporate debt. And so what I'm wondering is what is the data that when you go, when you're – when you were at the Fed that you pore over and look at and consider really important, and is there something out there that you're seeing – (inaudible) – that really is a concern?

MR. KOHN: Right. So there is – there has been a lot of borrowing by corporations, for sure, mostly in the bond market. The banks have been late – I mean, the banks have done balance sheet repair. Now bank loans are growing very rapidly, actually, business loans of late.

But the other side of that is the businesses have a lot of assets too and a lot of cash assets. So the other thing you hear is businesses are sitting on a bunch of cash. They're not using it to buy capital equipment. So it's not perhaps so threatening when they're issuing debt but they also have a lot of cash that

they could us to repay the debt if their capital spending doesn't generate the profits they anticipate.

I would say it's not so much the – the worrisome aspect now, to me, is not so much the quantity of corporate debt but the spreads, this so-called reaching for yield. So particularly on lower-quality corporate debt, so-called junk bonds, below-investment grade bonds, and on this leveraged lending that I talked about, lending to highly levered (sic) corporations, the spreads of interest rates over, say, a Treasury rate, the risk, the – what you're getting for taking the risk of lending to a lower-quality business has really shrunk quite dramatically. In some cases, it's at or below where it was before the crisis, when, in retrospect, people said these spreads were too narrow; people weren't getting compensated for the risk.

And likewise with the leveraged lending, the spreads are low and the terms of that lending have become very easy. So you hear things like no covenant or "covenant lite," meaning that the banks aren't demanding the same kinds of performance criteria from the businesses that they're lending to, even though they're highly lent – that might trigger a restructuring of the loan or trigger extra surveillance, even though this is highly leveraged.

So it's not so much the amount, it's the terms that I think people are beginning, correctly, to worry about.

And the concern would be, when interest rates start to rise back up again, you could get a double-barreled effect on these – this kind of lending. One barrel would be the base, the Treasury yields – the risk-free rates would rise. The other barrel would be the spread over risk-free rates would rise. And the investors who put a lot of money into this corporate debt would get hit both ways, and are they prepared, and what will be the consequences of that? And this is the sort of thing that the Fed is looking at very closely with respect to the banks and the – and the piece of the system that it oversees to make sure that if they are hit and they take a hit to their capital, they have enough left that they are still viable entities who can lend – access markets and lend, et cetera. So the

stress tests are looking at just this kind of stress, but there are lots of entities outside the banking system, and you don't know quite know what's going to happen out there. So that's – I think it's more about price.

Yellen has said that's – herself that some of these values are stretched, so – in her – in her metrics they are not out of historic ranges, but they're kind of at the edge of the historic ranges. So that – I think the worry is more about price than quantity.

Yes.

Q: Could you add to the worry list European sovereign debt problems – (off mic) – still being worked out?

MR. KOHN: So I would have – less so today than a couple years ago. I was – I have been surprised at how well they've been able to work through the problems, which are still very severe. So I think the so-called peripheral economies that are – as Greece and Spain and Portugal and Ireland – there are signs of life in those economies, at least a few of them. They have regained some competitiveness.

It's been extremely painful situation. Their unemployment rates are 20-something percent. Youth unemployment is 50 percent. These – this – you know, and some of these people may have jobs on the gray or black economy. You know, it may not be a totally – total – totally representative number, but it's horrible, it's bad, it's terrible, and they are just beginning to come back.

But I do think the threat of busting apart the eurozone, lots more sovereign defaults, has receded as the – as that economy has – as those economies have kind of stabilized and begun to come back. But it's – the threats are – they're – I do worry – it's a little bit like the values being stretched in junk bonds – whether the markets have driven down those yields so low that they're not really pricing in what's still a very remote but not zero probability of a – of a difficult – of a difficult problem. So it's – I don't expect anything, but I think there's a risk there that there could be a mistake, there

could be an accident, and the markets really haven't priced that. Portuguese bonds maybe – or I'm not sure about Portuguese, but some of these bonds that are trading at or below Treasury yields.

Yes.

Q: Could you talk a little bit about consumer demand, specifically U.S. consumer demand, and how it might be related to a slower recovery and corporate cash balance – (off mic)?

MR. KOHN: Well, consumer spending has picked up slowly, and it's been part – it's been just of a piece – "endogenous" would be the technical term – because incomes have been growing slowly, spending has been growing slowly.

We came into this recession with consumers spending too much. Savings rates were extremely low. They've been revised since then, but only from 0 to 1, or something like that. So people weren't saving enough for their retirements, the kids' education, all that stuff you're supposed to be saving for. They were counting on increases in their homes' value to finance these things, and that didn't happen.

So one of the first things that happened in the recession was the savings rate went up, so spending grew even more slowly than income for a while. It was extremely painful. It was hard. It was one of the reasons why the federal government in effect had to step in with extra demand and stimulus measures. That – the savings rates rose and then have kind of stabilized and fluctuated in narrow areas.

So I think the basic problem is the income isn't being generated. That's because the economy itself has only been growing 2, 2 ½ percent, so they're not getting more income, but also because wages have been stagnant. So it's – employment growth has been slow until six months or so ago. The per – what you're getting paid per hour is only going up as fast as prices, and you've had a huge shift in the income generated by a business from compensation to profits. And the owners of businesses get – I mean, that's one reason why

the stock market has gone up so well. And so you do get some effect on consumption from rising stock market, but in general wealthier people own the businesses – relative to us, wealthy – so you're redistributing income from middle-class and ordinary folks to wealthier folks. That's just part of this process. And I think that's also damped spending. So income growth has been slow.

And the businesses have been sitting on the cash, and the investment spending picked up in the early part of the expansion but then kind of slowed down and was very weak in the first quarter. And I think that's partly about – mostly about the point you've made, which was while consumer spending isn't that strong, so will there be enough demand for my output in the next year or two to justify increasing – so it kind of – it kind of feeds on itself, doesn't it? So you have a slow expansion, slow investment, slow consumption, and how do you break into that is very, very hard.

And in some sense, think of – think of what the Fed was doing as trying to break into that by having this really unconventional monetary policy to incent people to spend more than they otherwise would spend to compensate for the things holding them back. And I would say it was – as I noted, I think it was successful to a degree, but the expansion was still disappointing.

Yes.

Q: You mentioned earlier that whether it's hierarchal or not, one of the primary goals is to keep the inflation at 2 percent. For those of us less familiar, can you step back and explain why that's the goal – (off mic)?

MR. KOHN: So if – think what we – sure. Rather than another number or just why inflation at all?

Q: I guess both.

MR. KOHN: So let – both. OK. So let me start with why inflation at all and then get to why 2 (percent).

So why inflation at all? Because high and variable inflation is very bad for the economy, and we saw that in the 1970s. That's the classic – what lives in the memory of the Fed, even though there's probably no one there who was there in the '70s anymore, but sort of in the drinking water you get when you come in.

When there's high and variable inflation, it's very hard for businesses and households to make decisions. So you're looking – you're getting signals from the market. How is the market valuing the services I'm offering as I go out to the labor market? I'm a business. How is the market valuing the goods and services I'm trying to sell?

The – in a – in a stable inflation environment, low inflation/price stability environment, if you see the price of the services you're trying to sell in the market go up, either a business or a household, then you can sense, gee, people are valuing those services more. I ought to increase the supply. It's a – it's a signal. There's information coming from the market to the actors, the agents and the economy.

And when there's high inflation or variable inflation, it's very hard for the people in the economy to sort out what's a real signal about what I should do as a business or a household from what's just a product of this inflation, and so it distorts resource allocation decisions. I think just – people hate it. Then you do surveys of households, and I can remember in the – and this was the mid-, late '80s, so inflation had already come down, but somebody did a household survey and they – or a survey and said, what about inflation? How harmful? The economists said, well, it's not that harmful. If you can find ways of hedging against it or things are indexed to inflation, you know, it's not that bad. The households said, it's horrible. We hate it. We don't want it, and we feel like it's – it erodes our income, et cetera.

So they may misperceive some things, but it's not good. It – the Fed has often said the way to – one way to maximum employment is stable prices. So give people – and Paul Volcker and especially Alan Greenspan said price stability is

when households and businesses don't have to think about what the inflation rate is. They can just go make their decisions.

So why choose 2 percent? Why not 1 (percent) or 0 (percent) if inflation is that bad? Well, part of this is technical. These price indexes are flawed, and they are biased upward by varying amounts. So partly this is – you're – you don't have a good measure of inflation – doesn't take account of quality, improvements and that kind of thing.

But part of it is also think about the level of interest rates you get with this. So interest rates are defined – are defined by both real return on capital, the real interest rate, what you would expect to earn if you build a new piece of capital, what your preference would be spending now, spending later, some of these underlying things, and also an inflation premium on top of that. So if you think the value of your savings is going to be eroded by 5 percent a year just because of generalized inflation, you are going to ask for a 5 percent extra premium on top of the 2 percent or whatever you would earn as a real return. So interest rates would be 7 percent.

So let's think now – so when the Fed says 2 percent inflation, they're thinking about long-term interest rates of 4 percent, approximately, 3 ¾ to 4 percent.

If we had it even lower – let's say we had – we allowed for some measurement error and we said, well, let's aim for 1 percent inflation – then interest rates would be 3 percent.

Now let's think about what happens when bad stuff happens to the economy. So there's a shock that happens to the economy – the financial collapses, something happens abroad, whatever – that sends downward pressure on the economy. The Fed responds by lowering interest rates, I just said. If you start at 4 (percent), you've got 4 percentage points to play with before you hit 0 (percent). If you start at 3 (percent), you only have 3 percentage points to play with before you hit 0 (percent). Start at 2 (percent), you only have 2 percentage points to play with.

So one reason to aim for 2 (percent) rather than 1 (percent) is to make sure that nominal interest rates over time give the Fed enough room to move against adverse shocks without hitting that 0 (percent) lower bound, because when you hit the 0 (percent) lower bound, as we found out, it's very hard to stimulate the economy. Then you have to do these unusual things. So 4 (percent) gives you a little room.

Economists – coming out of the crisis, a number of economists have said 2 (percent) isn't enough inflation. I mean, look at the experience we just had. The Fed hit the 0 (percent) lower bound in the fall of '08 and has been struggling since then to stimulate the economy. Don't you think you ought to aim at 3 or 4 percent inflation? The IMF published a working paper like this, actually. The central banks have not responded well to that. I mean, I think partly they're feeling that it's taken a long time to build in these very anchored inflation expectations around 2 (percent) and they don't want to fiddle with that. If you went to – if you – if you said, we were aiming at 2 (percent), now we're going to aim at 3 (percent), people will say, well, gee, maybe 3 (percent) is on the way to 4 or 5 (percent). So it's – you don't want to play with people's expectations so much.

And you do have this issue that I started with: that the higher inflation is, the harder it is for people to make decisions about how much they should be saving for their retirement, how much they should be saving for the kids' education, that kind of thing.

So I think 2 percent is what universally has been agreed on among central banks, but it's a good question, and as I say, people have wondered whether 3 (percent) – Larry Summers, for example, hasn't suggested 3 or 4 (percent), but he worries that monetary policy will hit the 0 lower bound with some frequency. So a logical thing to do would be to aim for higher inflation. But the Fed has rejected that. So have the other central banks.

MR. KESSLER: We have time for one more question. Let's go right here.

MR. KOHN: I'll try to keep the answers short here. I'm sorry.

Q: Could you speak to the impact on other countries' demand for U.S. bonds – (off mic)?

MR. KOHN: And whether – what was the last --

Q: (Off mic.)

MR. KOHN: So the Fed has to – so there is an impact. It's not easy to measure and see directly – in the years leading up to the crisis, one of the mysteries of 2004, 2005 was the Fed was raising interest rates, and long-term rates weren't rising the way they ordinarily do in that story I told, right?

One reason, a major reason, was that other countries had lots of saving that they were investing in the United States. Sometimes that saving – one prominent example is China, who was accumulating that saving, in effect, by putting a lid on their exchange rate in order to induce export-led growth. So they had excess saving that they were investing in the United States, but other countries as well. Ben Bernanke, before he was chairman, gave a speech, and he talked about the global savings glut as a way of explaining why long-term interest rates hadn't risen as much as they should in the U.S.

The Fed needs to – so yes, the first part of your question – foreign demands for Treasury securities or other securities matter a lot. The Fed should in its decision-making take account of any of those effects on demand, prices, employment in United States and compensate for that with its monetary policy.

So I think a question you could raise is seeing the – what Greenspan called a conundrum, this lower – interest rates weren't rising as they should have – whether the Fed should have tightened a little more in the '03, '04, '05 period, and that's an accusation that, say, John Taylor makes, although he comes at it from a different angle. And as I said, I think early in my talk, I don't think easy monetary policy was kind of the reason for all these bubbles. Did it maybe contribute a little around edges? Probably a little bit, but it's something –

the Fed needs to think about what are interest rates in the U.S., how are they affecting demand in the U.S., why are doing what they're doing. Let's build that into our decision-making process.

MR. KESSLER: Well, thank you very much. That was really – (applause).

(Inaudible.) Thanks for coming out, everybody. September 19th – (inaudible) – and we'll be sending invitations out – coming up. Thanks again.

(END)