Testimony of Donald Kohn*

on

Promoting Economic Recovery and Job Creation: The Road Forward

before the

Committee on Financial Services

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Mr. Chairman and Members of the Committee,

I appreciate this opportunity to address the topic of promoting recovery and job creation. I can think of no more important economic topic facing the Nation today. We have been through the deepest and most persistent economic recession since the 1930s. The unemployment rate rose more than 5 percentage points in the recession and its decline in the recovery has been painfully slow. One consequence of that performance has been a very marked rise in the number of Americans who have been unemployed for a very long time. Not only is this an immense human and economic waste, but long-term cyclical unemployment can too readily turn into even longer-term structural unemployment as skills erode or fail to keep up with advancing technology and attachment to the labor force weakens. We must carefully consider possible additional policy steps to promote faster recovery and greater job creation.

The Economic Setting

At the same time, we also need to recognize that correcting the circumstances that led us to this pass—the bubble in housing prices and associated over-building of homes, the excessive leveraging by both households and lenders, the inadequate compensation for risk and weakening in lending standards across many forms of credit, the funding by both bank and nonbank lenders of long-term risky assets with short-term liquid debt, and the resulting financial crisis—will inevitably require some time. The recovery has been held back by the need for both households and lenders to rebuild financial strength through higher saving and more cautious lending; balance sheet repair is an inherently slow process. Growth has also been restrained by the need to work off a large overhang of houses from the bubble years; residential construction cannot play its usual role of leading the economy out of recession. Sluggish growth in many of our most important trading partners has held down demand from abroad. And the depth of the recession and weakness of labor markets has undermined both business and household confidence. Labor markets have been especially anemic. The flexibility of our labor markets is a key long-term strength of the U.S. economic system, but in the short-run it has enabled businesses to produce more with less, leaving households worried about their job prospects. Finally, this period has also been marked by highly uncertain government tax and spending plans on the state, local, and federal levels, and by an unusual level of new regulatory initiatives. I do not believe these initiatives and associated uncertainties are the main reason for the slow recovery, but they likely have contributed to it. I'll return to this subject later in my testimony.

Many of the headwinds facing the economy are abating. Household saving has risen to a level consistent with rebuilding wealth and reducing debt burdens and saving rates should not continue to rise at the rate they have in the past few years. Financial intermediaries have increased capital and reserves against bad loans; we see early signs of a more competitive lending environment with a slight easing of very tight terms and conditions for loans. Perhaps as a consequence, recent data suggest some acceleration in economic activity, and, with added fiscal and monetary stimulus undertaken late last year, many forecasters have raised their projections for growth this year. Still, most people expect the recovery to remain moderate and the unemployment rate to decline from its elevated level only slowly; so the subject of this hearing remains very much on point.

The recession and slow recovery and resulting high level of unused resources and intense competition in the economy have contributed to a substantial decline in inflation over the past few years. CPI inflation, which was running in the neighborhood of 2.5 percent in 2006 and 2007 before the financial turmoil hit has fallen to just over 1 percent. Headline inflation will probably move up some as the recent increases in energy prices get passed through to consumers. But core inflation has been exceedingly low—below 1 percent—suggesting an absence of underlying inflation pressures. If energy prices rise more slowly, as they have in recent weeks, and if the recovery is as gradual as most expect it to be, inflation is likely to remain quite damped over the next few years. Indeed, excess capacity of labor and capital will tend to put downward pressure on prices; what has kept inflation from becoming deflation are inflation expectations anchored somewhat above actual inflation.

<u>The Role of Monetary Policy in Promoting Economic Recovery and Job Creation</u>

As you know, I was a member of the Federal Reserve Board from August of 2002 until September 1, 2010. In that role, I participated in the decisions of the Board and Federal Open Market Committee, and I voted in favor of and fully supported the decisions made by these bodies. In my view, the actions of the Federal Reserve from the fall of 2007 on were crucial to containing the fallout on the economy and jobs from the financial crisis and promoting recovery and the resumption of job creation. Critically, these actions were taken in the context of also preserving price stability. When inflation is already low, the economy is weak and slack in labor and product markets abundant, no conflict exists between pursuit of the Federal Reserve's legislative mandates to promote maximum employment and price stability over the long run.

We acted forcefully with both the major macroeconomic instruments available to us—lending at the discount window and easing the stance of policy by lowering interest rates. These are separate instruments, but they are complementary and their use in both cases was intended to cushion the effects of the problems in the financial sector on the jobs and income of ordinary Americans.

From early on we could see that the difficulties of lenders in accessing liquidity were impeding their ability to extend credit to households and businesses. And if lenders needed to sell assets to obtain funding, those sales—often firesales—led to further declines in asset prices and further distress among lenders and their customers. Stabilizing the situation by lending against illiquid assets has been recognized as an essential function of a central bank in a financial crisis since the 19^{th} century. In this crisis, because lending had shifted in large volume to securities and securitization markets, we found it necessary to extend the provision of discount window credit beyond banks to the intermediaries in those markets and to the markets themselves. In doing so, we adhered to the basic principle of extending credit to solvent institutions against collateral at a penalty. In many cases the announcement and then the implementation of these programs helped to stem the panic, reduce the pressure on lenders, and stabilize markets. And those programs were terminated without adverse effects. Most of those loans have already been repaid—and repaid with profits, not losses, for the central bank and the taxpayers. The borrowing institutions were able to repay and reclaim their collateral; the penalty rates were sufficient to induce them to do so.

From early on we could also see that the tightness in credit markets and the drop in house and equity prices were going to weaken the economy and reduce employment. In response we eased the stance of monetary policy—at times aggressively. The National Bureau of Economic Research has designated the peak of the previous cycle as December 2007. We tried to head off the recession by easing somewhat in the fall of 2007. By January 2008, it was evident that the economy was slipping into recession as a consequence of the dislocations in financial markets and we eased aggressively through the spring. The reductions in our federal funds rate targets were intended to stop the slide in spending and prevent disinflation from becoming deflation.

In that regard, because the underlying financial situation kept deteriorating, the rate reductions were not as successful as I had hoped and the decline in economic activity steepened in the third quarter of 2008 and steepened substantially further in the fall of 2008 after the bankruptcy of Lehman Brothers, the distress of Merrill Lynch and AIG, and the panic that followed. To ameliorate the effects of these developments on growth and jobs, we cut our federal funds target effectively to zero and embarked on large-scale purchases of agency mortgage backed securities and, in March of 2009, of Treasury securities. With short-term rates already at zero, the only way to reduce longer-term interest rates further and ease financial conditions was to purchase intermediate- and long-term securities.

These purchases appear to have been effective, especially judging from the reactions in markets to their announcement. Declines in mortgage rates enabled some households to ease financial strains by refinancing their mortgages. Lower rates on mortgages and Treasury bonds, in turn, helped to reduce rates on business credit and to bolster asset prices, including in the stock market. Higher equity prices have bolstered household wealth, counteracting a portion of the decline in home prices. As I noted, I was at the Federal Reserve for all the actions I have just described and supported them wholeheartedly. They helped to prevent an even worse outcome—deeper recession, slower recovery, fewer jobs, with a real risk of slipping into deflation, perhaps of the sort that has plagued Japan for several decades now. By November of 2010, when the decision was made to resume large-scale asset purchases, I was no longer at the Federal Reserve and hence did not participate in policy discussions leading up to that decision. Judging from the statements of the FOMC and the speeches and testimony of Chairman Bernanke, the aims of this most recent action were similar to those we had when we took similar actions in the fall of 2008 and spring of 2009—that is, to lower intermediate- and long-term rates below what they otherwise would be, to have those rates feed through to easier financial conditions more generally to stimulate spending. As we discussed earlier, most economists see the economic recovery as likely to remain relatively slow and the decline in the unemployment rate very gradual from an unusually high level. In those circumstances, inflation is likely to be very low for some time. With the federal funds rate already at zero, further purchases of intermediate- and longer-term securities were the only way the FOMC had of promoting recovery and job creation—the subject of your hearing.

Such a policy is not without risks. There is a chance—relatively small in my view-- that inflation could begin to rise quickly and unexpectedly toward unacceptable levels, forcing the Federal Reserve to reverse course sooner and more rapidly than it or most other observers appear to expect, with disruptive effects on the financial markets and perhaps the economy. And even in the absence of a sudden surge in inflation the more gradual removal of accommodation could cause financial instability, given the extraordinarily low levels of many interest rates and associated distortions in asset markets. But the U.S. economy is producing far from its potential right now. All policies have risks on several sides, and the job of policymakers is to weigh those risks. The Federal Reserve has made what is, in my view, a credible case that it expects this policy to boost growth modestly while keeping inflation very low.

Promoting Economic Recovery and Job Creation: The Road Forward

A slow economic recovery is a predictable consequence of a financial crisis that impairs lenders and destroys wealth. The headwinds seem to be abating and many economists, myself included, expect that the pace of growth will pick up a little this year and the job market will improve somewhat. The natural healing powers of a market economy are being complemented by very accommodative monetary policy and by the boost to spending that will come from the fiscal package the Congress and the President agreed to late in 2010. To a considerable extent, patience may be the most potent weapon we have now to promote economic recovery and job creation. I doubt there are a set of policy actions that will greatly speed this process along. That said, I can identify a few broad areas in which policymakers can constructively contribute to faster recovery—in some cases by avoiding mistakes and reducing uncertainty.

The challenge for ***monetary policy*** will be to promote expansion without allowing fears of deflationary or inflationary spirals to take hold. Longer-run inflation expectations must continue to be well anchored for economic performance to improve. The Federal Reserve should continue to emphasize its willingness to adjust its policy based on the changing outlook for growth and inflation and its determination to return consumer inflation to the range of 2 percent or a little below that forms the central tendency of FOMC members' expectations for inflation over the longer-term, and then to keep it there.

High and variable inflation and inflation expectations weigh heavily on growth and job creation, as we saw in the 1970s. To keep inflation from rising above 2 percent the Federal Reserve will need to exit its extraordinary policies in a timely way. It has a number of tools that will enable it to raise short-term interest rates and absorb reserves when it decides that financial conditions should be tightened. I have no doubt that these tools, including interest on reserve balances and a number of new techniques to absorb excess reserves, will be effective at raising interest rates. In addition, the Federal Reserve will be able to resume the runoff of maturing securities and to sell securities into the market to reduce reserve balances. In the end, however, it will not be technical factors that determine whether the Federal Reserve makes progress toward the objectives it has been given. Rather it will be judgment and, critically, a continued high degree of independence from short-term political pressures so that it can exercise that judgment, that will determine its success.

In ***fiscal policy*** the lack of a clear and committed path to fiscal and debt sustainability is an important source of uncertainty for households and businesses and a risk to stability in financial markets. Demographic trends interacting with promises made by our government over several decades have put Federal debt on a steeply rising trajectory that clearly cannot be sustained. This problem has been exacerbated by the legacy of debt and interest payments left by the recession and the efforts to use spending increases and tax reductions to bolster demand. As the recovery gathers momentum, the public and private sectors will come increasingly into competition for scarce saving, causing interest rates to rise. The pressures on rates will be greatly intensified if the investors come to doubt the willingness of the Congress and Administration to confront and make the very difficult choices on spending and taxes that are required. At this point, households and businesses in the United States are very uncertain about the level and composition of government spending and taxation over coming decades. Surely, this sort of uncertainty tends to undermine the willingness of firms and households to make the investments that would promote longer-run economic growth. And as you deal with the budget situation, the Congress should take that opportunity to encourage growth by reforming our tax code by broadening the base and lowering marginal tax rates.

As I noted before, ***regulatory policy,*** including uncertainty about regulations, has probably been one of the factors holding back spending, though in my view it is probably not one of the main factors. To some extent, both greater regulation and uncertainty about that regulation have been byproducts of efforts to achieve important societal goals.

That certainly is the case for financial regulation, which you asked about in your invitation letter. In writing and implementing the Dodd-Frank legislation, the near-term costs of greater regulation are being weighed against the promise of a more stable and resilient financial system that will be able to avoid the types of systemic problems that have proven so disruptive and costly for jobs and incomes over the past several years. It is a complex, complicated, piece of legislation touching many aspects of our nation's financial system. Its net effect will depend mportantly on how it is implemented. The balance of regulation and resilience will also depend on other responses to the crisis: the work of the Basel Committee on Bank Supervision on global standards for bank capital and liquidity; the efforts of the Federal Reserve and other supervisors to improve their oversight processes; and the attempts at international coordination of standards and adherence to those standards by the Financial Stability Board.

I believe that on balance the new legislation will make our financial system stronger and more resilient to unexpected developments; will reduce the moral hazard effects of the too-big-to-fail phenomenon; and will increase transparency for better monitoring by both the supervisors and the private sector. I hope that implementation of the legislation is not materially slowed; in many cases putting in place some rules—even if they are adjusted later—will do more to relieve uncertainty and allow the private sector to adapt and move forward than would a generalized slowing of most implementation. Of course the Congress should continue to evaluate whether the benefits of specific requirements of the law and of the law's implementation more generally are likely to exceed their costs.

As our economy recovers from this painful episode, it must be re-oriented from excessive dependence on debt and especially from dependence on foreign saving and capital inflows to finance spending in excess of production. In particular we must rely much less on consumption and residential housing construction to support jobs and incomes than we were earlier and much more on investment and net exports. Fiscal and regulatory policies must be structured to reduce government borrowing over time and to encourage private saving and business capital spending. Monetary policy must contribute to a macroeconomic environment characterized by stable prices and moderate fluctuations in economic activity to facilitate longer-term planning by governments, households, and businesses. None of this will come easily or quickly. But it is essential to promoting longer-term economic growth and job creation.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Donald Kohn	None
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Donald L Kohn	

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