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Lessons Learned: Donald Kohn

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Lessons Learned

Donald Kohn

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Kohn, an economist, is a 40-year veteran of the Federal Reserve System. He served as a member of the Board of Governors, and was vice chair, from 2002-2010, which included the years of the global financial crisis (GFC). In that role, Kohn was also a voting member of the Federal Open Market Committee (FOMC) and was also was involved in the bailout of American International Group (AIG), the largest during the crisis. This "Lessons Learned" is based on an interview with Kohn in March 2020, as the world was grappling with the COVID-19 pandemic. He discussed not only his experiences during the previous crisis, but also how policymakers were approaching the 2020 crisis.

Leadership makes a difference—both negative and positive.

Kohn spoke about the impact of leadership from different perspectives during the two crises. His reaction to the leadership at AIG was critical. He thought that the "less than stellar" AIG leadership greatly complicated the Fed's efforts to assist it:

> What we didn't know and what was very disappointing to me in my conversations with AIG executives, including the CEO in those few days over the weekend, was they didn't have a very good sense of their own liquidity needs, and how they might develop over the coming weeks. They didn't have a good sense of how they were going to get out of the mess, as I was reminded a few years ago when that court case was being adjudicated.

In contrast, Kohn observed that the leaders in place on the government side—particularly Ben Bernanke at the Federal Reserve Board of Governors, Timothy Geithner at the Federal Reserve Bank of New York, and Henry Paulson at the Treasury Department—showed great strength, led teams that coordinated closely, and produced efforts that proved effective against great odds and unprecedented challenges.

Kohn also praised leadership at the Fed in 2020 for its quick and forceful response to the COVID-19 pandemic:

> Boy, I would say Jay Powell certainly has moved forcefully, quickly, adopted many of the things we did, but then expanded them to meet the needs of the time. The current Federal Reserve is being very, very proactive and not being held back.

Leaders must remain open to ideas from others.

Among the unconventional policies the Fed pursued as the GFC unfolded was to purchase mortgage-backed securities (MBS), the troubled financial assets at the root of the crisis, to support liquidity in that market. The idea for this asset-purchase program originated from the staff of the Trading Desk of the Federal Reserve Bank of New York. "They wanted to go in and help restore market functioning, similar to what we're seeing today," Kohn recollected. Even though it seemed like an obvious and great idea, then it was outside of the Fed's unusual purview. However, Kohn recalls that Chairman Bernanke and others were immediately open to exploring the idea:

> I think it's a responsibility of the leadership of the organization to remain open to things that hadn't been tried before and to listen with an open mind to people around them who are bringing these new ideas and to actively solicit the new ideas. One of the strengths of Ben Bernanke's leadership was that he would send out what he called blue-sky emails, asking his colleagues and his staff for new ideas, different ideas.

In a crisis situation, assume the worst and prepare for the worst.

Reflecting on the nature of crises, Kohn counseled speedy, forceful action, "Try to head off the worst that can happen. Don't wait for the markets and the commentary to catch up with you," Kohn counseled.

He recalled a conference in 2007, before the worst of the financial crisis had become apparent:

> I guess it must have been at Jackson Hole 2007; the focus of the discussion was moral hazard. At that time, in retrospect, we'd hardly done anything. We'd made the discount window cheaper. We'd encouraged people to borrow. Maybe we'd eased policy a little bit. Then, there was all this discussion that, "Oh my God, you're creating moral hazard. There's a *Bernanke put*, et cetera." Ignore that, I guess would be the advice. Just go fast. Go hard. Go soon. Correct the moral hazard issues later with regulation like in Dodd-Frank. Don't worry about it in the middle of the crisis.

Learning from the past is important: The experiences of 2007-09 are helping policymakers as they face the crisis of 2020.

In his writings and speeches, Kohn has outlined four broad lessons policymakers should take away from the experience of the global financial crisis. In his interview, he reflected on steps that have been taken to put those lessons into practice.

1. Recognize the considerable effects that financial developments can have on the economy and the uncertainty that attends the economic outlook during periods of financial stress.

Kohn said, “in 2008, for most of the models we were using, the only thing that mattered was the federal funds rate, actual and expected. The model didn’t take into consideration a credit availability problem. Basically, they were looking through the financial sector to the real economy. What we learned was you can’t do that. You might be able to do that in peacetime, but you can’t do it in wartime.”

In the years since, Kohn reflected, the Fed and outside economists have striven to see relationships between the financial sector and the rest of the economy more clearly.

2. Be sufficiently aggressive in cutting the federal funds rate as financial conditions deteriorate.

Kohn was supportive of the Fed’s actions to combat the COVID pandemic. He applauded their swift decisive movements, which were consistent with his general thinking on what should be done in a crisis:

> If the conditions are deteriorating, it’s better to cut it too much than too little. You can always take it back later. If inflation gets going, you can always act against that. There’s no limit on the upside of the policy variable of the federal funds rate. There’s just a limit on the downside. That asymmetry suggests that it’s better to be aggressive and try to cushion the economy from the really bad stuff happening, because once it happens, you’re really stuck, and then you’re with the unconventional policies.

3. Use asset purchases to achieve additional accommodation when the capacity to cut policy rates does not provide a sufficient response to economic conditions, and do so with less concern about the associated risks.

Kohn recalled that when the Fed started asset purchases in late 2008 and then added to it in March of 2009, it hadn't been done before and it was just being undertaken by a few other central banks like the Bank of England. “No one quite knew what was going to happen.”

Economists outside the Fed warned of inflation and of the difficulty of tightening monetary policy when it was time to exit the unconventional programs. Neither risk materialized. Kohn observed that,

> But now that we have had that experience [with asset-purchases during the GFC], in 2020, the Fed has moved aggressively with asset-purchase programs. I think certainly the inflation and exit issues shouldn’t hold back the Fed—and haven’t held back the Fed—over the last couple weeks.

4. Provide forward guidance on interest rates in order to signal a policy reaction function that differs from history or market expectations.

The Fed’s approach to forward guidance has evolved, Kohn said. In 2008, when the FOMC began to provide some forward guidance about its possible actions, it started with “some vague words," Kohn recalled. "Then, over time, I think the forward guidance was strengthened and tied more explicitly to emerging economic circumstances and even to specific dates." He believes this was a very positive development:

> [Forward guidance became] a more powerful tool in the Fed's toolkit as it became more sophisticated and more specific. I think you need to communicate to the market. It's not so much about what's happening right now. They can see what's happening right now. I think the risk that we worried about, and that I think Brian [Sack] and I wrote about, was that the market would have these rates rising faster than the Fed intended to raise them once the economy began to recover.

Kohn is of the opinion that providing forward guidance helps guard against the market acting prematurely on beliefs about future central bank actions.

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