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Prospects for the Financial System and Markets
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Donald Kohn is former vice chairman of the Federal Reserve and a 40-year veteran of the Federal Reserve System. He advised Federal Reserve Chairman Ben Bernanke throughout the 2008-2009 financial crisis. Kohn is currently a senior fellow in the Economic Studies Program at the Brookings Institution. He assesses the current state of financial markets and the Fed's monetary policies, particularly its recent decision to expand its portfolio of intermediate and long-term Treasury securities (aka QE2).

Key observations include:

- Bond spreads indicate that the securities market has recovered from the trauma of the financial crisis. Junk bond spreads now exceed their pre-crisis levels, indicating a more healthy appreciation for risk, which had been lacking.

- Corporations are stockpiling very large amounts of cash. They are displaying caution and are averse to making capital investments and hiring, slowing recovery.

- Stock prices have recovered considerably and interest rates remain at historical lows, but credit is not flowing well in the financial markets.

- Banks have substantially tightened their lending to businesses and the public. For those who don't have access to the bond markets and are dependent on banks, credit remains tight as banks rebuild their balance sheets.

- The Federal Reserve Act gives the Fed three objectives: maximum employment, stable prices, and moderate long-term interest rates.

- Given that unemployment is well above the structural unemployment rate and core inflation is at a record low, and with the outlook for only moderate increases in employment and ongoing low inflation, the Fed determined that it was falling short on two of its three objectives.

- In such circumstances, normally the Fed would lower the Fed Funds Rate to lower the short-term interest rate and stimulate the economy. But that rate was already at zero, and so the Fed took the next logical step to directly affect these financial conditions by buying intermediate and long-term Treasury securities -- that is, it launched the policy known as QE2.

- The purchases the Fed undertook via QE2 are a natural extension of its efforts to achieve its Congressionally-mandated objectives. It has, however, moved into uncharted territory.

- Expansion of the Fed's balance sheet has stoked fears of inflation. The Fed has devoted considerable effort to developing so-called exit tools to tighten monetary policy and raise interest rates when the time comes to do so.

- Meanwhile, it is using its supervisory authority to be sure that the nation's largest banks are prepared for an increase in interest rates when that happens.

- Other countries -- particularly China -- can address the inflationary impulse they are feeling from the United States by tightening their own monetary policy and allowing their exchange rates to appreciate.

- The key to the success of QE2 -- and broad economic recovery -- is confidence that the Fed will not let inflation get out of control. That is, that the Fed will take the hard but necessary steps to protect the purchasing power of the dollar, which will remain the world's reserve currency for the foreseeable future.